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Report to the Ranking Minority Member, Committee on Foreign Relations, U.S. Senate

June 1992

INTERNATIONAL TAXATION

Problems Persist in Determining Tax Effects of Intercompany Prices

GAO/GGD-92-[illegible]

GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-246704

June 15, 1992

The Honorable Jesse Helms
Ranking Minority Member
Committee on Foreign Relations
United States Senate

Dear Senator Helms:

This report, prepared in response to your request, discusses the Internal Revenue Services' (IRS) administration of section 482 of the Internal Revenue Code and makes recommendations to the Commissioner. It also discusses various alternatives we analyzed for dealing with the arm's length pricing approach that underlies transfer pricing activities.

As agreed with your ofice, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time we will send copies to other congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget, and other interested parties and make copies available to others upon request.

The major contributors to this report are listed in appendix V. Please contact me at (202) 275-6407 if you or your staff have any questions concerning the report.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Executive Summary

Purpose

In the 1980s, the amount of foreign direct investment in the United States rose dramatically—from $83 billion to $401 billion. The share of world manufacturing trade between related parties also increased significantly.

Responding to a request from Senator Jesse Helms, GAO studied (1) whether foreign-controlled companies might have underpaid income taxes by improperly using transfer pricing; (2) what factors, if any, affected the Internal Revenue Service's (IRS') ability to determine and recover any potentially underpaid taxes; and (3) what alternatives to dealing with transfer pricing existed. Senator Helms was concerned because foreign-controlled corporations (those U.S. corporations in which at least a specified percentage of voting stock is held by a foreign party), while reporting over $540 billion in receipts in 1986, still reported losses of about $1.5 billion, possibly because of inappropriate transfer pricing practices.

Background

Intercompany transfer prices are prices companies charge related parties for goods and services transferred on an intercompany basis. If the transfer prices are calculated improperly, so are the U.S. related party's U.S. income and U.S. income taxes. If prices claimed for transactions between a company and its subsidiary operating in a different country are set too high or too low, income is, in effect, shifted from one country to another and taxes may as a result be avoided.

IRS uses the authority provided by section 482 of the Internal Revenue Code to allocate income among related parties if it believes transfer prices have been inappropriate. For instance, if a foreign company charged its U.S. subsidiary $1,000 for a product and IRS determines the comparable transaction price between unrelated parties—or arm's length price—would have been $500, IRS subtracts $500 from the subsidiary's expenses and proposes an adjustment of $500 to its income. At a corporate income tax rate of 34 percent, the subsidiary would owe an additional $170 in federal income taxes.

Results in Brief

Foreign-controlled corporations often reported lower gross profits, net income, and U.S. taxes paid as percentages of sales than their domestically-controlled counterparts did. However, although statistics like these would be expected if foreign-controlled companies were setting improper transfer prices, these statistics do not prove actual impropriety. For instance, they could result from foreign-controlled companies lowering their sales prices to increase market share.

The dollar implications of the transfer prices that IRS questioned in the late 1980s and early 1990s is significant. For example, from 1987 through 1990 IRS tracked through its appeals function $5.6 billion in proposed section 482 adjustments to income. Based on IRS figures that IRS said had to be heavily qualified, about $2 billion of the proposals were sustained. The foreign-controlled amount processed was a small part of the total, but the portion could be larger in the future, assuming IRS continues its relatively recent focus on foreign-controlled firms.

Various factors affected IRS' ability to determine and recover section 482-related taxes possibly underpaid. These factors included (1) difficulties in using section 482 regulations and the reality that much time must be spent researching and presenting the facts of each section 482 case; (2) problems in obtaining tax records, especially for foreign-controlled companies; (3) IRS' staff size and its staffing allocation system; (4) IRS' slowness in aggregating management information for analysis; (5) IRS' examination findings often not being upheld by its appeals process or the courts, a condition for which IRS was studying the underlying causes; and (6) a relatively decentralized IRS effort aimed at transfer pricing problems.

Recent congressional and regulatory changes help address such factors as access to records. However, more can be done in the areas of staffing, management information, and the use of centralized transfer pricing expertise.

Despite the recent changes, GAO does not expect problems with section 482 to be resolved at any time in the near future. This is due, for instance, to the continuing fact-sensitive nature of section 482 cases, with each case presenting a unique set of facts and circumstances requiring consideration. Although GAO analyzed various alternatives to the current arm's length pricing approach, all present problems, as does another alternative recently developed in proposed Treasury regulations.

GAO's Analysis

Extent of the Problem

Certain facts suggested the existence of a widespread transfer pricing problem among foreign-controlled firms, but these facts did not prove the existence of a widespread problem.

For instance, foreign-controlled companies often had lower gross profits and net income in relation to their sales than U.S.-controlled corporations did and paid a lower percentage of their sales in taxes. (See p. 33.) As a more specific example, for companies in each of the five wholesale industries with the largest amount of foreign-controlled sales—those covering machinery, motor vehicles, metals, electrical goods, and other durable goods—the 1987 gross profit (sales minus the cost of the goods sold) of foreign-controlled corporations was or appeared to be a lower percentage of sales than the gross profit of U.S.-controlled firms was.

A lower gross profit to sales ratio for foreign-controlled firms indicates they paid more for goods as a percentage of sales than U.S.-controlled firms did. One reason for this difference could be improperly high transfer prices paid by foreign-controlled companies, but another could be low sales prices by foreign-controlled firms as they seek to increase market share. (See p. 22.) Also, in all comparisons like these, other factors must be kept in mind. For instance, the fact that five foreign-controlled firms paid 19 percent of all foreign-controlled taxes in 1987 could skew overall tax-to-sales ratios.

IRS has challenged the transfer prices of both foreign- and U.S.-controlled corporations, resulting in large proposed adjustments to companies' income. For example, as of April 30, 1991, proposed section 482 adjustments for at least 32 foreign-controlled companies were under consideration by IRS appeals officials, accounting for recommended increases to income of $1.7 billion. This amount was about 13 percent of the $13.1 billion for section 482 cases involving either foreign- or U.S.-controlled corporations that GAO identified in the appeals inventory. Thus, most of the dollar value of transfer pricing issues was not concentrated in foreign-controlled cases, but that could change assuming IRS' relatively recent examination focus continues. (See pp. 29-31.)

Not all of IRS' proposed adjustments will survive the appeals process. According to the best IRS figures available for 1987 through 1989, 74 percent of the dollar value of proposed section 482 adjustments for foreign-controlled corporations was not sustained. (See p. 30.)

IRS identified hundreds of smaller foreign-controlled firms with potential section 482 problems for audit, and by April 1992 it was examining 2.9 percent of all foreign-controlled corporations. Previously, IRS had used its resources mostly on the largest foreign-controlled firms. In 1990, IRS testified that it would cover 55 percent of foreign-controlled assets by

examining 1.3 percent of foreign-controlled corporate tax returns, less than the 2.6 percent IRS audit coverage for all corporations. (See p. 32.)

IRS' Section 482 Management Challenges

Initiatives in the late 1980s and early 1990s by IRS and Congress were aimed at IRS problems in dealing with section 482. For example, the number of staff working in international enforcement was increased. IRS was also studying why many of its examination findings did not survive its appeals process. Problems previously pointed out were that poorly developed cases entered the appeals process and poor communications existed between international examiners and appeals officers. (See p. 46.)

In another initiative, by passing the Revenue Reconciliation Act of 1989 and the Omnibus Budget Reconciliation Act of 1990, Congress increased IRS' access to previously hard-to-get foreign-held records. Access problems had been exacerbated by IRS' emphasis on quickly closing large cases, which meant that taxpayers benefited from delaying tactics as IRS ran out of examination time. Also, IRS examiners did not use their relatively limited summons procedures aggressively in pursuing information.

It is too soon to tell if IRS' past practices of quickly closing cases and unaggressively using summons procedures will continue and prevent IRS from effectively using the new recordkeeping legislation. IRS does have an initiative to close large examination cases earlier than it did before the initiative. Also, because over 90 percent of foreign-controlled corporations are relatively small, they could be exempt from certain aspects of Treasury's new recordkeeping regulations, even though, in general, small corporations' income tax compliance declined significantly in the 1980s. (See pp. 41-43.)

In spite of the various changes made, IRS still did not have an adequate system for continually assessing its international examination workload and determining the appropriate number of international examiners. According to a 1991 internal IRS report, IRS had no staffing model for deciding if the number of its international examiners and economists should be increased, and IRS districts analyzed for the report had no consistent method for determining staffing needs, particularly for reviewing companies not in IRS' large case program. According to IRS officials, IRS allocated its 1991 and 1992 staff increases on the basis of an informal survey of regional staffing needs rather than on a systematic study of workload. (See p. 40.)

Also, IRS had transfer pricing management information deficiencies similar to those that GAO reported in 1981. According to the same 1991 IRS report, IRS had not systematically analyzed overall trends of noncompliance with international tax provisions to see how to best use its international examiners. In addition, the information on intercompany transactions that was required from foreign-controlled companies was not always reported, timely, or well used. (See pp. 43-44.)

During GAO's review, IRS was in the early stages of aggregating various types of information that would help it pinpoint specific section 482 trends, learn more from information returns on intercompany transactions, and track the eventual disposition of section 482 examination issues. In 1991, IRS established a new group to analyze international workloads and trends. (See pp. 44-45.) GAO believes that because IRS has so many management information efforts ongoing and has had management information problems for such a long time, a formal plan would help coordinate its various projects. The plan would cover how IRS will discern and act on trends in types of section 482 findings, in intercompany data submitted on information returns, and in section 482 case disposition.

IRS' various priorities affected transfer pricing examinations. Because of a priority on using resources where the greatest tax change was likely to result, IRS was reluctant to examine companies with net operating losses—a characteristic common among foreign-controlled firms but also possibly among firms for which transfer pricing issues could arise. Similarly, the time needed to develop a complex transfer pricing case and make a sound price adjustment was at odds with an emphasis on closing cases early. (See pp. 49-50.)

GAO believes that the two recently appointed transfer pricing examination specialists and/or their administrator could help balance the importance of transfer pricing work against other IRS priorities that arise and raise for discussion any conflicts that persist. They could also be involved proactively in areas where much reliance was placed on local initiative.

For instance, analyzing data tapes of foreign-controlled companies was a local responsibility, and officials in one IRS location GAO visited had not analyzed the data provided. Similarly, IRS did not use the data tape information for planning, on a nationwide basis, which locations needed what resources based on the extent of those locations' potential transfer pricing problems. With their transfer pricing expertise, the new specialists

and/or their administrator could help analyze data and determine staffing needs. They could also help ensure that all the various international management information initiatives that are being taken are continually examined with an eye toward section 482 specifically. (See pp. 51-52.)

Alternatives to the Way Arm's Length Prices Have Been Used

In spite of recent changes, section 482 cases will still have their own unique sets of facts and circumstances, requiring IRS and taxpayer efforts on a case-by-case basis. Also, because the large volume of intercompany transactions increasingly involves new high-technology goods, determining arm's length prices will continue to be demanding. Factors like this mean IRS will continue to find successfully dealing with any improper transfer prices challenging. Also, the initiative promoting advance pricing agreements between taxpayers and IRS has hurdles to overcome as well as great promise, and the extent of its benefits will not become known for several years. (See pp. 62-66.)

GAO studied various alternatives for replacing or modifying the traditional use of the arm's length approach for transfer pricing cases. They include (1) formulary apportionment, which allocates a multinational corporation's income according to the proportion of various factors, such as payroll, in each jurisdiction where the multinational has activity; (2) a minimum tax on assets, which would overcome problems in allocating income and deductions by providing a way of computing income based on assets; (3) a business transfer tax, designed to tax goods and services when they enter the United States from abroad and also tax the value added to them within the United States; (4) expanded safe harbors, which would leave prices of particular goods and services unchallenged by IRS if they fell within specific ranges; and (5) expanded methods of allocating income among related parties, which would use comparisons within industries as the basis for allocation. (See pp. 68, 72, 76, 78, and 82.)

Each of these alternatives aims to ease the case-by-case burden that has plagued transfer pricing and add some degree of standardization to the process. For example, formulary apportionment would attribute income on the basis of some simple formula, using, for instance, U.S. and worldwide property, payroll, and sales figures. It would preclude the arduous search for whether transactions that needed to be done at arm's length really were done at arm's length.

Each alternative also has problems. The first three alternatives would require either that countries worldwide agree to drop the arm's length

standard, which is the international norm, or that the United States fundamentally change its tax structure. Expanding safe harbors could create a revenue loss for the U.S. government. The last alternative mentioned could induce foreign countries to retaliate against U.S. companies operating within their borders if they perceived that the alternative was a departure from the arm's length approach. (See pp. 93-94.)

However, this alternative shares a key feature—comparing income indicators from different companies—with the essence of the approach Treasury developed in its January 1992 proposed regulations. The extent to which Treasury's proposal will reduce uncertainty felt by taxpayers, administrative burden, and the need for case-by-case analysis is unresolved. Although the alternative GAO studied could be perceived by some as a greater departure from the traditional arm's length approach than the Treasury proposal is, it could in many ways also result in greater certainty, less administrative burden, and less case-by-case analysis. However, without international agreement, to the extent that this or any other alternative deviates or is perceived to deviate from the arm's length standard, disagreements with other countries might increase administrative burden and case-by-case analysis. (See p. 94.)

Recommendations

IRS should (1) continually assess its international staffing needs to best meet its international workload; (2) formally plan how it will discern and act on trends in types of section 482 findings, in intercompany data submitted on information returns, and in section 482 case disposition; and (3) involve its newly appointed section 482 specialists and/or their administrator in continually analyzing international management information initiatives from a section 482 perspective, helping determine staffing needs for section 482 issues, and raising for discussion policies that conflict with an ongoing emphasis on transfer pricing. (See p. 54.)

Agency Comments

The Department of the Treasury and IRS provided written comments on a draft of this report. These comments are presented and evaluated in chapters 3 and 4.

IRS commented that our recommendations were consistent with efforts it had been undertaking for several years and that it had significantly improved its international compliance efforts. In this light, it said that it was already working on the matter covered by the staffing

recommendation, but, although it described commendable initiatives, it did not address the specifics of the other two recommendations. (See pp. 54-55.)

While commenting favorably about the draft report, Treasury suggested the draft omitted several points that GAO has since clarified. (See p. 94.)

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Figures

Abbreviations

BTT	Business transfer tax
CEP	Coordinated Examination Program
FCC	Foreign-controlled corporation
IE	International examiner
IRS	Internal Revenue Service
SOI	Statistics of Income

Introduction

Increases in Foreign Direct Investment in the United States

During the 1980s, foreign direct investment[1] in the United States increased dramatically compared with direct investment overseas by U.S. multinational corporations. Foreign direct investment in the United States in 1980 was about $83 billion, compared to an estimated $215 billion of U.S. direct investment abroad. By 1989, however, foreign direct investment in the United States was estimated to be about $401 billion, while direct investment abroad by domestic firms had increased to about $373 billion.

This change in investment patterns generated interest in the potential for tax underpayments resulting from inappropriate transfer pricing policies of foreign corporations who had invested in U.S. entities. As a former IRS Associate Chief Counsel in charge of IRS international legal matters wrote, transfer pricing in general was by far the most important area of audit and litigation controversy involving international taxes.[2]

Description of Transfer Pricing

A transfer price is the price charged by one unit of an organization, such as an affiliate, department, or division, for a product or service supplied to another unit of the same organization. Corporations use a variety of methods to determine these intrafirm prices, thereby affecting the distribution of profits among organizational units.

Underpayment of U.S. taxes by foreign-controlled corporations (FCCs) can result from inappropriate transfer pricing, which can take two forms.[3] "Inbound" transfer prices cover the prices a foreign parent corporation charges its controlled U.S. entity. "Outbound" transfer pricing generally refers to transfers between U.S. corporations and their controlled foreign affiliates, but it also covers transfers that a U.S. subsidiary makes to its foreign parent. Both types of pricing pose enforcement problems for IRS.

Because of its controlling authority, a parent with a subsidiary operating in the United States can charge the subsidiary excessive prices for goods and services rendered (for example, $1,000 instead of $500). This raises the subsidiary's expenses (by $500), lowers its profits (by $500), and shifts the income ($500) outside of the United States. At the 34 percent corporate

[1] As used by the U.S. Department of Commerce, foreign direct investment is the accumulation over time of foreign investment capital in all U.S. business enterprises that a foreign person owns 10 percent or more of, either directly or indirectly.

[2] D. Kevin Dolan, "Intercompany Transfer Pricing for the Layman," Tax Notes (Oct. 8, 1990), p. 212.

[3] An FCC in this context is a U.S. corporation, 50 percent or more of whose voting stock is owned by a foreign individual, partnership, corporation, estate, or trust. As will be described later, legislation in 1989 and 1990 cited a 25-percent ownership threshold, but tax returns filed through 1990 included the 50-percent cutoff.

income tax rate, the subsidiary will pay $170 less in U.S. taxes than if the $500 profits were attributed to it.

The advantage to the corporate group of not paying U.S. taxes at the 34 percent rate is obvious if the income is shifted to a tax jurisdiction that has a lower effective tax rate. However, because the U.S. corporate tax rate is less than that of some other countries, would a company find it advantageous to still shift income out of the United States? In its comments on our draft report, the Department of the Treasury refers to the possibility that multinational corporations in high-tax countries might shift income to levels in the chain of production away from the level that might be subject to a transfer pricing inquiry.

Internal Revenue Code Section 482

Ever since the 1928 Revenue Act, tax statutes have authorized the Commissioner of the Internal Revenue Service (IRS) or the Secretary of the Treasury to allocate income among related parties in order to prevent tax evasion or to clearly reflect the income of the parties. IRS carries out the current statutory provision—section 482 of the Internal Revenue Code—by considering what a price would have been if the parties had not been related to each other. Such a price is called an "arm's length" price. If IRS finds a difference between the price one related party charges another and the arm's length price, it can propose an adjustment to the taxpayer's income.

Section 482 gives the Treasury Secretary very broad authority to make these adjustments. The authority to determine true taxable income extends to any case in which it appears that a related party's income does not reflect business done on an arm's length basis.

The Tax Reform Act of 1986, the only substantive change to transfer pricing legislation since 1928, required the transfer price for intangible assets to be commensurate with the income attributable to that asset. That is, the transfer price should reflect the income that the asset generates. Before the 1986 act, the law did not specifically mention intangible assets, and taxpayers had strong incentives to transfer them to related parties in low tax jurisdictions, resulting in indefinite tax deferral or effective tax exemption.

Section 482 Regulations

Transactions covered. Treasury regulations detail how section 482 applies and under what circumstances. They cover five specific types of

intercompany transactions: the sale of tangible property, the use of tangible property, the transfer or use of intangible property, the performance of services, and loans or advances.

Methodology for transfer price determination. The regulations are complex. For example, they discuss various methods that can be used in determining an arm's length price for tangible asset sales. These methods include the comparable uncontrolled price method, the resale price method, the cost plus method, and any other acceptable method, also known as the "fourth" method. In addition, the regulations provide guidance for loans and advances, and proposed regulations discuss the intangible asset changes made by the Tax Reform Act of 1986 (see chapter 4).

IRS' Organizational Structure for Processing Transfer Pricing Cases

Functional offices. An IRS transfer pricing review can involve the following IRS functions, each of which is explained more fully below: examination, appeals, competent authority, and litigation. IRS officials carry out these functions at various district, regional, and national offices. The key national offices are the Office of the Assistant Commissioner (Examination), the Office of the Assistant Commissioner (International), and the Office of Chief Counsel.

Examination structure. Examinations are done by teams, operating primarily within districts, that may include a case manager, revenue agents, economists, computer specialists, international examiners, and others. Examinations of corporations that meet specific criteria, such as certain dollar values of gross assets and gross receipts, are part of the Coordinated Examination Program (CEP), which covers about 1600 large corporations operating in the United States.

IRS examiners are responsible for auditing the corporations operating within their districts. These examiners generally are provided direction by the Assistant Commissioner (Examination), and they are in charge of full examinations. International examiners (IES) are a special subgroup of examiners and are provided direction by the International Enforcement Division within the Office of the Assistant Commissioner (International). IES are responsible for examining all international issues that arise in examinations, including transfer pricing.

When an examiner proposes adjustments that increase a corporation's taxable U.S. income, the company has the option of (1) agreeing with the

assessment and paying it; (2) paying all or part of the assessment in order to avoid interest charges, while retaining the right to appeal the adjustment; or (3) paying none of the additional taxes and moving the case directly into the appeals process or competent authority. If the company does not want to appeal its case in IRS, it can take the case to court.

Appeals process. When a corporation chooses to appeal a proposed adjustment, IRS appeals officers throughout the country are to serve as objective interpreters of the facts presented by both IRS examiners and company officials. An appeals officer reviews the IRS examiner's workpapers, may meet with the case manager, and hears the corporation's position before making a decision about the validity of the assessments. Factors to be considered include the quality of the evidence documented during the examination and IRS' vulnerabilities if the case were to go to court. Examiners, on the other hand, are not to consider hazards of litigation.

Litigation. IRS' Office of Chief Counsel establishes litigating positions for foreign tax issues in the courts, and international special trial attorneys around the country do actual litigation. IRS attorneys may also provide legal advice while corporations are being examined.

Competent Authority. Countries enter into tax treaties with each other to avoid double taxation of multinational corporations doing business in both jurisdictions and to prevent evasion of either's income taxes. Double taxation occurs when a specific item is included in the income of two related enterprises in different countries, the item is taxed in both countries, and neither country provides a credit against its tax for tax paid to the other country.

Nations have generally appointed officials referred to as those nations' "competent authorities" for dealing with tax treaty matters covering related parties. The Assistant Commissioner (International) is the U.S. competent authority and is responsible for negotiating section 482 cases with the competent authorities of the U.S.' tax treaty partners.

A company within the United States may elect to seek assistance from the competent authority on a voluntary basis as soon as it learns that a treaty country plans to formally propose adjustments to income. The company does not have to request services at this point—it may choose to enter into the competent authority process at any point as the case progresses. However, IRS officials told us they encourage companies to go the appeals

route before going to the competent authority. Also, when litigation is involved, the competent authority may not accept a case without the consent of IRS' Chief Counsel.

When a case is accepted for competent authority resolution and double taxation is determined to exist, the U.S. competent authority may do one of several things. It may eliminate double taxation unilaterally by reducing the U.S. tax, it may negotiate with the foreign government to attempt to persuade it to reduce its tax, or it may try a combination of these measures.

Major Recent Studies of Section 482

Since 1980, four major studies of transfer pricing have focused on both the inherent difficulties with section 482 and IRS' administration of section 482 cases.

GAO report on transfer pricing. The first of these studies was a report issued by GAO in 1981[4] that focused on outbound transfer pricing and suggested a number of measures that IRS could implement to improve its administration of section 482. It found that very few of IRS' total recommended section 482 adjustments were based on a true arm's length price and that both IRS and the taxpayers experienced administrative burden and uncertainty.

IRS internal report. In 1984, IRS issued an internal report done by the Assistant Commissioner (Examination).[5] This study, responding to previous critiques of the Service's "use and misuse" of section 482, concluded that IRS' administration of section 482 was effective. It also developed data that it believed would help IRS identify the frequency and trends of section 482 adjustments, geographic areas of noncompliance, and profiles of businesses that would most likely be susceptible to improper shifting of income.

Treasury Department White Paper. In 1988, the Treasury Department issued a White Paper—the result of an in-depth study of section 482.[6] The White Paper was done in response to a Conference Committee recommendation before the Tax Reform Act of 1986 that Treasury study

[4]IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (GAO/GGD-81-81, Sept. 30, 1981).

[5]IRS Examination Data Reveal an Effective Administration of Section 482 Regulations, Department of the Treasury, Internal Revenue Service, Publication 1243 (4-84).

[6]A Study of Intercompany Pricing, Treasury Department, (Oct. 18, 1988.)

whether the existing regulations could be further modified in any respect. The resulting report recommended many improvements, including (1) revising information returns related to intercompany pricing, (2) more aggressively pursuing noncompliant taxpayers who were slow to provide pricing information, (3) changing the section 482 regulations to provide a more appropriate methodology for allocating income relating to intangible assets, and (4) developing a "fourth method" to determine transfer prices in the absence of comparable transactions.

House Subcommittee on Oversight study. In 1990 the House Ways and Means Committee, Subcommittee on Oversight, completed a study of transfer pricing that focused on inbound transactions and possible tax underpayments by foreign corporations with subsidiaries operating in the United States. This study found that over half of the 36 foreign-owned companies the Subcommittee investigated paid little or no federal income tax over a 10-year period. It concluded that the inherent difficulties in determining arm's length transfer prices were exacerbated by the lack of adequate staffing in IRS and the difficulties involved in obtaining adequate information from taxpayers.

Recent Legislation and Regulatory Initiatives

Measures have been taken in recent years that attempted to alleviate some of these concerns. For example, in the wake of the Tax Reform Act of 1986, Treasury proposed new section 482 regulations in January 1992 to take into account the ideas in the White Paper and the comments and discussion generated by them. The proposed changes focused on the treatment of intangible assets but included parallel modifications to the section 482 tangible property regulations. The final regulations are to be effective for taxable years beginning after December 31, 1992.

The Revenue Reconciliation Act of 1989 and the Omnibus Budget Reconciliation Act of 1990 provided IRS with improved access to books and records in the custody of foreign corporations. Treasury recently issued regulations implementing these provisions. The 1990 law also provided IRS with the authority to impose penalties on taxpayers for substantial valuation misstatements due to transfer pricing and mandated that Treasury study the effectiveness of its new compliance tools.

Treasury and IRS completed the study in April 1992 and presented their conclusions in a hearing before the Ways and Means Oversight Subcommittee. Although they regarded their conclusions as tentative given the relatively short time that had elapsed since changes were

implemented, they were encouraged. On the basis of preliminary data, the study concluded that recent legislative changes would increase compliance with section 482, and in light of IRS' administrative actions, further legislation would be premature.

Objectives, Scope, and Methodology

Objectives. In responding to a request from Jesse Helms, Ranking Minority Member, Senate Committee on Foreign Relations, we had three objectives: (1) to determine whether FCCs in various industries might have underpaid federal and state income taxes by improperly using transfer pricing; (2) to determine what factors, if any, affected IRS' capacity to determine and recover any potentially underpaid taxes; and (3) to evaluate alternatives to the current arm's length approach to transfer pricing. Senator Helms was concerned because FCCs, while reporting total receipts of almost $543 billion in 1986, still reported losses of about $1.5 billion, possibly because of inappropriate transfer pricing practices.

Scope and methodology—objective 1. To determine whether federal taxes might have been underpaid, we examined indicators of possible underpayment. Specifically, we analyzed Statistics of Income (SOI) data covering FCC and U.S.-controlled companies' income, taxes, and other factors, and we compiled information on cases in various stages of IRS processing in which section 482 issues were found. We also estimated the impact of specific IRS findings on the potential underpayment of state taxes.

Scope and methodology—objective 2. To determine whether factors existed affecting IRS' effectiveness in section 482 cases, we interviewed IRS, foreign government, and private industry officials; studied documents covering section 482; attended conferences and congressional hearings; and studied 12 specific section 482 cases in depth at various district offices. As described further in appendix I, we selected the cases on the basis of their location, the industry and IRS processes involved, and the perceptions of IRS officials about IRS' success or lack of success in dealing with section 482 issues.

Scope and methodology—objective 3. To evaluate alternatives to the current arm's length approach to transfer pricing, we selected ideas that illustrated the wide variety of ways possible to deal with transfer pricing problems. We analyzed each one using specific criteria based on accepted principles of taxation.

Scope and methodology—general. We did our field work between March 1990 and October 1991 and did our work in accordance with generally accepted government auditing standards. See appendix I for further details on our scope and methodology.

The Department of the Treasury and the Internal Revenue Service provided written comments on a draft of this report. Their comments are presented and evaluated in chapters 3 and 4.

Magnitude of FCC Transfer Pricing Problems Unknown but Greater Than IRS Had Identified to Date

This chapter discusses indicators of the extent to which FCCs may be using transfer pricing to pay less U.S. taxes than they should be paying. The full extent of the transfer pricing problem is not known. This chapter describes

- statistics derived from the IRS SOI database that show differences between FCCs and domestic corporations in gross profits, net income, and U.S. taxes paid that could indicate improper pricing but do not prove that FCCs are setting improper transfer prices;
- the magnitude of FCC section 482 problems recently handled by IRS;
- the potential effect on state taxes of possibly improper FCC pricing practices; and
- indicators of possible transfer pricing problems in FCCs not examined.

Statistics Derived From SOI Database

IRS uses SOI data to compile statistical information on corporations filing tax returns in the United States. The database includes a weighted sample of both domestic and FCC tax return data. SOI data can be used to examine trends in income, taxes paid, and other items recorded on tax returns.

As described below and in appendix II, the data show differences between FCCs and domestic corporations, with the FCCs generally showing, as percentages of sales,[1] lower gross profits,[2] lower net income,[3] and lower taxes than U.S.-controlled companies. Some speculate artificially high transfer prices caused these lower FCC percentages. The data contain indicators of potential improper transfer pricing by FCCs in that they are based on breakouts by year, industry, country, and whether corporations did or did not have net income.

Still, the data do not prove that FCCs have set improper transfer prices because other factors, such as attempts to increase market share, newness of investment, extent of leverage, fluctuating exchange rates, and managerial skills and experience, can contribute to the differences. According to a recent paper, about half of the differential between FCC and U.S.-controlled rates of return could be explained by such factors as exchange rate changes increasing FCC costs more than domestically

[1] "Sales" refers to line 1(c) of IRS Form 1120—U.S. Corporation Income Tax Return. It consists of sales (or gross receipts) less returns and allowances.

[2] Gross profit equals sales less the cost of goods sold.

[3] "Net income" is taxable income before any net operating loss deduction or special deductions.

controlled costs.[4] The paper added that the unexplained half of the differential was due to transfer pricing distortions or other explanations.

The ratio estimates presented in this chapter and in appendix II are based on sample data and are thus subject to error. We assessed the reliability of the ratio estimates for 1987 using the procedure described in appendix I and footnoted the report where data questions remain; we did not use this procedure for 1983 through 1986 because of time and resource constraints.

Overall differences between FCCs and domestic corporations. In all 5 years analyzed—1983 through 1987—domestic corporations, as percentages of sales, had higher gross profits and net income and paid more tax than their foreign-controlled counterparts. Further, close to 60 percent of all domestic corporations had net income in any given year between 1983 and 1987, while only 41 to 44 percent of FCCs had net income in these years. Also, in 1987, about 70 percent of FCCs nationwide did not pay U.S. taxes,[5] compared to 57 percent of domestic corporations, a breakdown similar to those in 1985 and 1986. Finally, between 1983 and 1987, the percentage of profitable FCCs having no U.S. income tax liability[6] ranged between 29 and 37 percent, compared to a range of 17 to 22 percent for profitable domestic corporations. (See app. II for further details.)

The above statistics and those in appendix II show that (1) higher FCC sales from year to year did not automatically translate into higher FCC net income from year to year, (2) a smaller percentage of FCCs than domestic corporations were profitable, and (3) a lower percentage of profitable FCCs than profitable domestic corporations paid tax. The statistics do not by themselves show the presence or absence of transfer pricing problems. For example, the decline in net income despite rising sales of the FCCs could have resulted from an attempt to increase market share at the expense of profits. Also, aggregate data can be skewed by a relatively few outlying corporations, such as the five FCCs that paid 19 percent of all FCC taxes in 1987, raising the overall tax-to-sales ratio for all FCCs as a group.

[4]Harry Grubert of the Treasury Department; Timothy Goodspeed of Florida International University; and Deborah Swenson of Duke University, "Explaining the Low Taxable Income of Foreign-Controlled Companies in the United States," presented before the National Bureau of Economic Research, August 1991.

[5]"Tax" refers to the total tax paid after all credits and additional taxes. These data were available only for years 1985 through 1987.

[6]"Income tax" is the tax before credits and additional taxes. This information was available for all 5 of the years examined.

Differences within large industries. The SOI database allows for industry-by-industry comparisons of U.S.- and foreign-controlled corporations. Such comparisons are based on the industry code, which is reported or assigned to each corporation during statistical processing. The industry code represents the corporation's principal business activity, that is, the activity that accounts for the largest portion of the corporation's total receipts. However, a given return might be for a company engaged in several business activities. To the extent that corporations are engaged in many types of business activities, the data presented here are not entirely related to the industrial activity under which they are shown. Further, companies transcending many industries are grouped in the same industry with relatively tiny corporations, allowing for much variation within a group.[7]

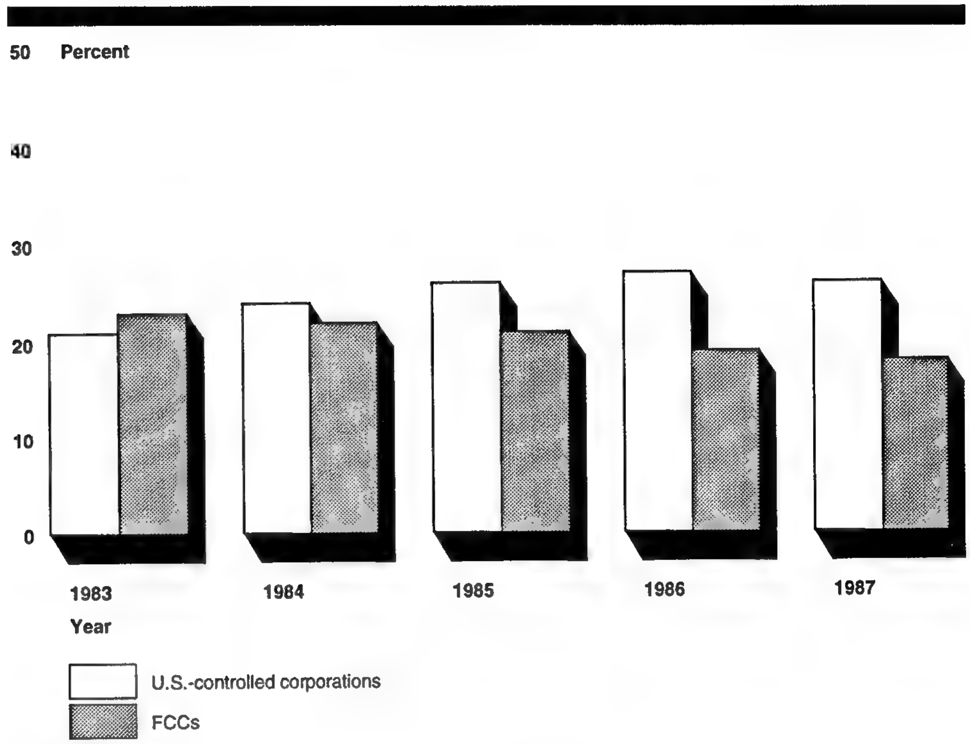
These qualifications should be kept in mind when comparing sub-groups (for example, U.S.- and foreign-controlled companies) within a given industry code because conclusions drawn from such comparisons could be misleading. For instance, we noted that large companies selling major products we know to be competing with each other in the marketplace are not necessarily in the same industry code; an FCC can be classified as a wholesaler, and a competing domestic company can be categorized as a manufacturer. Recognizing this data limitation, we directed our analysis at comparing FCCs and U.S.-controlled corporations in these industries over time rather than on attempting to draw conclusions about transfer pricing practices.

Figure 2.1 shows that in all years except 1983, FCCs, compared to their domestic counterparts, had a lower ratio of gross profits to sales in an aggregate of the "top 10" industries in terms of sales.[8] The top 10 accounted for 50 percent of 1987 FCC sales for all 180 industries but for only 15 percent of all U.S.-controlled sales.

[7]Although these limitations exist, we believe that any attempt to realign industry groups would also create problems. For example, if a company were in three or four major industries, classifying the company in any one of them would, under the current industry classification system, keep it from being classified in the others.

[8]These industries were other food product manufacturing (industry code 2096); industrial chemicals, plastics and synthetics manufacturing (2815); petroleum refining (2910); machinery, equipment, and supplies wholesale (5008); motor vehicles and automotive equipment wholesale (5010); metals and minerals wholesale (5050); electrical goods wholesale (5060); other durable goods wholesale (5098); grocery stores (5410); and holding companies (6749).

Figure 2.1: Gross Profit as a Percentage of Sales in Top 10 Industries, 1983-1987



Note 1: The industries selected represented 50 percent of foreign-controlled sales in 1987.

Note 2: Estimates are based on sample data.

Source: SOI data.

In the aggregate, FCCs in these industries had lower net incomes in relation to sales than U.S.-controlled corporations did. In 1987, they paid less tax as a percentage of sales than domestic corporations did, but in the 2 previous years, they paid more. Appendix II contains statistics on selected expense items for the 10 industries.

Differences within wholesale industries. Five of the 10 industries with the highest FCC sales in the United States were wholesale industries. As a group, these wholesale industries showed greater differences between FCCs and domestic firms in gross profit, net income, and taxes paid as percentages of sales than the other five industries taken together. Because of this, we decided to look at the wholesale industries in greater detail.

These industries—machinery, equipment, and supplies; motor vehicles and automotive equipment; metals and minerals; electrical goods; and other durable goods—accounted for 29 percent of all FCC sales in 1987 but only 4 percent of all U.S.-controlled corporations' sales.

Table 2.1 shows that gross profit, net income, and taxes paid as percentages of sales were lower for 1987 for the wholesale group than for the other five industries taken together. Data for 1983 through 1986 show that both FCCs and U.S.-controlled wholesale corporations as a group consistently had lower gross profits as a percentage of sales than corporations in the other five industries. The differences were much greater for FCCs than for U.S.-controlled corporations. Net income as a percentage of sales was also much lower for both foreign- and U.S.-controlled wholesalers than for companies in the other five industries in years 1983 through 1985. In 1986, however, net income for foreign-controlled wholesalers was higher than net income for the other five industries taken as a group. Taxes paid as a percentage of sales was higher for wholesalers than for the other five industries for both foreign- and U.S.-controlled corporations in 1985 and 1986, contrary to the case in 1987. Appendix II has breakouts for each of the five wholesale industries for 1987.

Table 2.1: Gross Profit, Net Income, and Taxes Paid as Percentages of Sales, 1987

	Gross profit	Net income	Taxes paid[a]
Domestic			
Wholesale group	21.6	1.5	0.7
5 other industries	27.1	5.1	0.9
Foreign			
Wholesale group	10.7	0.5	0.5
5 other industries	27.9	1.6	0.7

Note: Estimates are based on sample data.

[a]Because of the large amount of variability in the data for domestic industries, comparing the taxes paid ratios for the domestic wholesale group and the five other domestic industries could be misleading.

Source: SOI data.

Again, while the various ratios suggest that FCCs in particular industries may be setting improper transfer prices and therefore paying less tax, uncertainties about the make-up of individual corporations in a given industry code as well as the unknowns mentioned earlier require that any conclusions be formed carefully.

Differences by country group among wholesalers. Japanese-controlled corporations dominated the FCCs in the wholesale industries we analyzed. In 1987, they accounted for 71 percent of all FCC sales in the five industries. By contrast, the European-controlled corporations from the three European countries with the highest sales in these industries[9] accounted for only 12 percent of sales collectively. Wholesale corporations owned by parents in 40 different countries accounted for the remaining 17 percent of sales.

Table 2.2 compares gross profit, net income, and taxes paid as percentages of sales for Japanese-, European-, and U.S.-controlled corporations in the wholesale industries in 1987. Using these ratios, Japanese-controlled wholesalers differed more from U.S.-controlled corporations than European-controlled wholesalers did in gross profit and taxes paid. However, net income as a percentage of sales was much lower for European-controlled wholesale firms than it was for either Japanese- or U.S.-controlled wholesalers. As shown in appendix II, using gross profit as an example, these relationships may not be constant over time and thus should be viewed with caution.

Country-to-country differences such as we describe here and in appendix II raise questions that go beyond the scope of our analysis and could be the focus of further IRS study. While higher cost of goods sold, lower net income, and lower taxes paid ratios could indicate improper transfer pricing among firms controlled from particular countries, IRS audits are needed to separate transfer pricing issues from such factors as managerial skill and attempts to increase market share.

[9]The three countries were the United Kingdom, West Germany, and France. Our analysis of European wholesale corporations includes the corporations in these three countries only. We do not provide more refined analysis by country or industry here or elsewhere in this report lest we disclose individual firms' tax data.

Table 2.2: Comparison of Gross Profit, Net Income, and Taxes Paid as Percentages of Sales for Wholesale Corporations, 1987

	Gross profit[a]	Net income	Taxes paid
Japanese-controlled	8.8	0.5	0.5
European-controlled	16.0	0.0[b]	0.7
U.S.-controlled	21.6	1.5	0.7

Note 1: The corporations included here are in five wholesale industries that accounted for 29 percent of all foreign-controlled sales in 1987.

Note 2: Estimates are based on sample data.

[a]Because of the large amount of variability in the data, comparison of the gross profit ratios for European- and U.S.-controlled wholesale corporations could be misleading.

[b]European net income was 0.03 percent in 1987; 0.0 in table is due to rounding.

Source: SOI data.

Magnitude of Section 482 Problems Recently Dealt With by IRS

1990 findings by international examiners. For 1990, IRS specifically tracked all closed international examination cases that had total proposed adjustments to income of $20 million or more. For each of these cases, IRS tracked major issues of $100,000 or more. Out of the 2,152 total cases closed in fiscal year 1990, 73 with adjustments of $11.9 billion were tracked.

Adjustments totaling $6 billion related to 37 section 482 cases.[10] Proposed adjustments to income may or may not result in increased tax collections, depending on such things as whether a company has offsetting adjustments, offsetting corporate net operating losses carried over from other years, or success in challenging the proposed adjustment.

At least 11 of the 37 companies were FCCs, accounting for $1.6 billion, or about 27 percent, of the $6 billion in section 482 proposed adjustments. (We did not receive information from IRS on the ownership status of another three companies, accounting for about 1 percent of the $6 billion.) The section 482 dollar totals for FCCs and U.S.-controlled corporations were significantly affected by a few companies that comprised large

[10]We did not audit the section 482 numbers that appeared in the tracking system. If we noticed that a particular number was significantly different from other information we had received from IRS, we discussed the matter with IRS and adjusted the number in the tracking system where appropriate. The IRS official overseeing the section 482 examination numbers believed that those in the tracking system were the most accurate, were subject to the most controls, and accounted for the great bulk of the dollar value of international examiners' proposed adjustments. These numbers were the bases for periodic reports to IRS management.

percentages of the totals. The 11 FCCs were in 8 industries, only 3 of which were wholesale.[11]

1989 findings by international examiners. For 1989, based on a slightly different IRS tracking system and other large cases that we noticed, 43 companies had section 482 proposed adjustments totaling $4.8 billion. Of these 43 companies, 12 were FCCs with proposed section 482 adjustments of about $691 million, or about 14 percent of all the proposed section 482 adjustments. Again, a few large adjustments significantly affected the comparison of FCC and other adjustments.[12]

Because IRS' focus on FCCs was relatively recent, it is not unexpected that the problems found by international examiners that involved FCCs were small in comparison to the total section 482 effort. It is important to note that FCC cases closed in 1989 related to tax years 1979 through 1987. The number of FCC cases may rise in the future as IRS gains more experience with them.

Section 482 problems in ongoing CEP examinations. As of September 30, 1990, IRS identified 91 ongoing CEP cases for which its examination officials thought there might be section 482 issues developing. This number was up from 66 on IRS' first list like this, for March 31, 1988. Using another 1990 CEP list on which IRS identified foreign-controlled companies from various sources, we found that at least 22 of the 91 CEP companies were foreign-controlled as of June 30, 1990. The 22 FCCs were in 11 "industry types," with half of them being in the automotive and electronics areas.

Cases recently closed in appeals. The percentage of section 482 cases closed in appeals from 1987 through 1989 involving FCCs as opposed to U.S.-controlled corporations was relatively small, again not an unexpected

[11]According to the only aggregate IRS information available on all section 482 findings for 1990, international examiners closed 270 large and small cases with proposed inbound and outbound section 482 adjustments. The 270 cases represented 12.5 percent of the 2,152 international examinations closed in 1990. When IRS matched the 270 cases against its master listing of FCCs at our request, it found that 70 of them involved FCCs. However, IRS could not vouch for the reliability of these numbers. We noticed that some section 482 cases that appeared in an earlier list did not appear on the list of 270 cases. We also noticed that other information we received from IRS on specific companies did not always agree with the ownership data IRS gave us for the 270 individual cases.

[12]When we asked for information on proposed section 482 adjustments for 1989, IRS supplied us with a list of 122 closed cases. Based on IRS' matching of data files, 21 of these cases involved FCCs. However, other ownership information we received from IRS on specific cases did not always agree with the ownership status IRS reported to us for the 122 individual cases. Also, the list of 122 cases did not include many examinations with section 482 issues closed in 1989 that we noticed in other sources.

situation given the relatively low audit effort devoted to FCCs to date.[13] Out of 143 companies with proposed section 482 adjustments to income of $3.8 billion, 18 with $757 million in proposed adjustments were foreign-controlled.

The percentage of proposed adjustments sustained in appeals from 1987 through 1989 was slightly lower for section 482 cases involving FCCs than it was for section 482 cases involving domestic corporations.[14] About $200 million of the $757 million of section 482 adjustments proposed for FCCs was sustained—a sustention rate of 26.5 percent. The sustention rate for all section 482 cases was 29.8 percent ($1.1 billion sustained of $3.8 billion proposed). Moreover, seven of the eight FCCs with the largest proposed section 482 adjustments had sustention rates lower than 15 percent. The sustention rate on other individual cases varied widely.

Because IRS did not have a programmer available, we did not receive the same level of detail for cases closed in 1990. Overall, however, IRS sustained 52 percent, or about $932 million, of $1.8 billion in proposed section 482 adjustments. Of the 10 largest dollar issues closed in appeals in 1990, the 52 percent sustention rate was higher than that of 5 other issues. The 37 percent sustention rate in 1989 was greater than or equal to the sustention rate of three other issues.

Overall, IRS closed more section 482 cases in appeals in 1989 and 1990 than cases involving any other international issue. The sustention amount—the part of the proposed adjustment that appeals sustains—for the section 482 cases far exceeded the amount for cases involving every other international issue except one in 1989 and 1990.

Cases open in appeals. At least 32 FCCs, including some docketed for trial, were included in the 228 cases that had large proposed adjustments

[13]Appeals does not track every issue relating to section 482 but believes it captures the large ones by focusing on the largest issues in cases that meet certain tax deficiency criteria.

[14]IRS heavily qualifies its sustention rate figures. A representative of IRS' national appeals office regarded them as good "ballpark" estimates but cautioned against using them more extensively. He said case closure information was not collected for sustention rate purposes, and IRS did not have quality controls over it. However, it was the best information IRS had on sustention rates and, as will be described in chapter 3, IRS was studying its sustention rates in detail.

pending and had section 482 issues open in appeals as of April 30, 1991.[15] The total amount of proposed section 482 adjustments for these 32 firms was $1.7 billion. This was approximately 13 percent of the $13.1 billion section 482 disputes in appeals as of that date. Another 2.6 percent of the $13.1 billion proposed adjustments was for taxpayers for whom we did not receive enough information from IRS to determine ownership.

Cases in litigation. Ten of the 31 large section 482 cases listed by IRS as pending in litigation and providing important litigation vehicles at September 30, 1990, were FCCs. Based on IRS calculations, they accounted for $319 million in tax deficiencies (as opposed to income adjustments) relating to section 482 issues, 10 percent of the total section 482 tax dollars in the 31 litigation cases as of that date.

Effect on State Taxes

Although 5 states did not have a corporate income tax for 1989, 45 plus the District of Columbia did.[16] The jurisdictions with the tax often used a figure from the federal income tax return as the starting point for the state tax computation, but few states had major parts of their state tax law modeled on federal law.

State officials we interviewed told us inappropriate transfer pricing definitely can affect the level of state taxes paid. As mentioned earlier, certain IRS recommended section 482 adjustments for 1989 would raise FCC income by about $691 million. Using various assumptions described below, the IRS proposals could translate into an extra $48 million or so in state taxes.

The $48 million is admittedly just an estimate because it assumes (1) all IRS proposed adjustments were sustained in the IRS appeals process and in the courts, (2) state income was adjusted by the same amount as federal income, (3) the FCCs' income was allocated around the United States in proportion to each state's share of employment by foreign-controlled U.S. affiliates, (4) each state taxed the added income at its maximum 1989 corporate income tax rate, and (5) the income adjustment is not offset by such items as corporate losses carried over from other years.

[15]The data on cases open in appeals came from IRS' Centaur system. This system was put into place in September 1990 for the appeals and legal services functions of the chief counsel's office to use in managing large cases and tracking issues. Centaur replaced the appeals tracking system used in previous years for large cases and provided IRS with what it considered to be more complete and accurate data than it had before. However, IRS was still not satisfied with the data's reliability and continued to review data quality.

[16]Michigan had a "single business (privilege) tax" applying to income from in-state business activity; we are classifying it as a corporate income tax for our purposes.

Indicators of Section 482 Problems in Corporations Not Examined

Potential section 482 problems in smaller firms. IRS officials with whom we spoke did not know if IRS efforts to date had successfully revealed the magnitude of the FCC section 482 problem. IRS had concentrated its examination efforts on large FCCs. In 1990, IRS testified that while it planned to examine only 1.3 percent of FCC returns for 1987, it would cover 55 percent of FCC assets and 52 percent of gross receipts for that year. The 1.3 percent, however, was significantly less than the 2.59 percent audit coverage IRS reported for all corporations for 1990. By April 1992, IRS noted in its report on section 482 that it was examining about 1,300 of the approximately 45,000 FCCs in existence, a coverage rate of about 2.9 percent.

IRS officials in two districts told us of their analyses that suggested that hundreds of small and medium-sized firms that had not been examined may have been using transfer pricing to avoid paying U.S. taxes. During our review in the last half of 1990 and the first half of 1991, IRS was in the early stages of examining more smaller FCCs, and IRS officials believed that collectively the small and medium-sized corporations might point toward a significant compliance problem. One district found that 71 percent of its FCCs paid no taxes in 1987, with the situation being especially prevalent among wholesale distributors.

Studies of FCCs in other districts showed similar percentages of firms not paying tax. In industries we examined in more detail, we found that an estimated 71 percent of the smallest companies—those with sales of $10 million or less—did not pay 1987 tax, compared to an estimated 39 percent of larger companies.

In its April 1992 report on section 482, IRS noted that the number of FCC returns being examined outside the coordinated examination program more than doubled since July 1990.

Fragmented corporate entities. Some small and medium-sized firms that escaped the scrutiny afforded to larger cases were "fragments," or related subsidiaries of the same foreign parent. If consolidated, some groups of fragmented subsidiaries could form a corporate entity large enough to be included in the CEP program.

IRS recently began doing coordinated examinations of fragmented entities. It planned more efforts in this area because officials believed that there might be significant transfer pricing abuses among fragmented corporations.

Simultaneous examinations. In responding to our 1981 report on problems with IRS' section 482 enforcement, IRS said it had established simultaneous examination programs to protect U.S. interests in international tax enforcement. In simultaneous examinations, the United States and another country at the same time examine related parties under their jurisdictions. The examinations have usually focused on reallocating the profit or other economic gain attributed to a tax haven to the respective entities the governments were examining.

Even though it considered that simultaneous examinations were very good techniques for developing transfer pricing issues when profits were in tax havens, IRS had only 12 cases in its simultaneous examination program from fiscal years 1986 through 1990. It could not tell us how many of these involved transfer pricing. IRS and foreign officials said that more of these examinations were not done because of such reasons as country differences in language and audit periods (some tax authorities auditing specific tax years sooner than IRS does). IRS also cited budget, staffing, and planning considerations.

In its fiscal year 1991 business plan, the Office of the Assistant Commissioner (International) recognized the need for more simultaneous examinations. Also, an internal IRS report recommended changing the governing criteria to make it easier to generate more of these examinations. IRS officials have said that IRS is backing away from its previous practice that a tax haven be involved whenever a simultaneous examination is to be started.

Conclusions

Many statistical indicators show that FCCs often had lower gross profits and net incomes in relation to their sales than U.S.-controlled corporations did, and that they paid a lower percentage of their sales in taxes. These are patterns that would be expected to exist if FCCs were inappropriately using transfer pricing. However, none of the indicators provides conclusive proof of improper FCC transfer pricing, and, therefore, none gives a good idea of the extent to which a transfer pricing problem might exist. Other factors such as fluctuating exchange rates may account for some of the differences between FCCs and domestic corporations, and industry-specific statistical breakouts have their own shortcomings.

In its examinations, IRS identified billions of dollars of proposed changes to corporations' income due to what it considered to be improper transfer pricing. However, many of these proposed adjustments were not sustained

through IRS' appeals process, and more of them involved U.S.-controlled corporations than involved FCCs.

Some signs existed that IRS had other FCCs to examine for potential transfer pricing problems. Until recently, IRS had not concentrated examination efforts on smaller FCCs, and IRS officials believed a significant compliance problem might exist there. In a related vein, it had done few comprehensive examinations of FCCs that were all fragments of the same larger entity. Finally, it had made little use of its program for doing examinations simultaneously with foreign governments.

Factors Affecting IRS' Capacity to Determine and Recover Taxes Underpaid

During our review, we found the following six factors that affected IRS' ability to deal more effectively with transfer pricing issues:

- the complexity of section 482 regulations and the difficulty of applying them to cases that are factual rather than legal in nature;
- problems with staffing levels and systems;
- delays in receiving taxpayer information;
- a management information system still in its early stages;
- examination findings often not sustained in appeals or litigation, a condition for which IRS was studying the underlying causes; and
- slowly evolving IRS expertise related to FCC transfer pricing issues and a relatively decentralized effort to enforce transfer pricing regulations.

Much has been happening in these areas. To enhance the improvements that are already being made, we are making recommendations for ensuring that international workload and staffing are more continuously studied, that improvements to management information systems are more comprehensively planned, and that the new program of specialists is more broadly used.

Settling Transfer Pricing Issues Means Applying Complex Regulations to Factually Unique Cases

1981 GAO report. According to our report, the section 482 regulations and the resulting enforcement process had created unacceptable uncertainty and significant administrative burdens for both corporate taxpayers and IRS examiners. Because examiners had difficulty finding comparable uncontrolled prices when examining tangible assets, intangible property, loans and advances, services, or rents, they made few adjustments based on them. Instead, for tangible assets they relied mainly on the "fourth method" of price determination.

1988 Treasury White Paper. The White Paper stated that section 482 issues were almost always factual, as opposed to legal, in nature. What this means is that much time must be spent researching and presenting the facts of a transfer pricing case before the important legal issues can be addressed. The main administrative difficulty, according to the White Paper, was that the regulations did not specify a method of income allocation to be used when comparable uncontrolled prices did not exist for intangible assets. This was important because the Treasury regulations strongly emphasized finding comparable unrelated party transactions, but comparables were often either absent or misused when transfers of intangible property were involved.

More recent statements. At the 1990 transfer pricing hearings held by the Subcommittee on Oversight, House Committee on Ways and Means, the Joint Committee on Taxation underscored the complexity of the regulations. The Joint Committee stated that regardless of which method is used for tangible assets, much controversy arises between IRS and taxpayers in establishing proper comparables. During the hearings, the IRS Commissioner used plastic hubcaps as an illustration of the problem. How does anyone determine and value comparable hubcaps if no other company manufactures a similar part and no other company's distributors sell the part?

The IRS Commissioner further testified that transfer pricing cases were inherently factual and subjective in nature. They required a great deal of cost, pricing, and market data about the taxpayer and its competitors and, as a result, were extremely difficult, time-consuming, and costly to develop. At other times, we heard IRS officials and business representatives say that documenting and putting together a section 482 case required substantial resources from both IRS and the taxpayer involved. Both IRS and corporate taxpayers characterized the result of the adjustment process as unpredictable.

Implications. In one case we studied in which IRS officials believed the subsidiary was paying too high a price for the goods received from its parent, the IE told us that IRS tried three of its economists before it found one willing to take on such a complex issue. We were told that the three wanted to end the case without proposing adjustments because they knew the difficulty they would face in sustaining them through IRS. The IE also said that the original special trial attorney assigned to the case did not understand the issue and refused to accept it.

In another case, which involved interest expense related to the purchase of inventory from a parent, IRS believed the arrangement was not at arm's length. Because of requirements in the section 482 regulations, the examination team had to go sequentially through a hierarchy of methods in a very difficult search for companies and functions that were similar to the case being examined. IRS eventually used the "fourth method," but according to the IE, by the time the examination was finished 3 or 4 years had elapsed. Even though going straight to the "fourth method" would have required less time, an IRS district official considered this case to be an example of one IRS handled successfully.

In light of the 1988 White Paper, in January 1992 IRS proposed new section 482 regulations covering transactions involving intangible assets and making parallel changes covering tangible assets. The factual nature of cases, however, will continue to some degree because the proposed regulations require considering the facts and circumstances of the case in doing certain analyses.

International Examiner and Economist Staffing Levels Being Enhanced but Need Periodic Study

Staffing growth. In testifying at the 1990 transfer pricing hearings, the IRS Commissioner described IRS international staffing levels as inadequate given the increase in the number and complexity of multinational corporate tax returns. We have since noted that during the 1980s the number of IEs increased from about 225 to about 500 and the number of economists from about 14 to about 40. From 1978 to 1987, the number of FCC returns filed with IRS rose from about 14,000 to almost 45,000. After receiving 1990 congressional guidance to enhance international enforcement, IRS planned, for fiscal years 1991 and 1992, to increase the number of IEs to 582, the number of IE managers from 52 to 60, and the number of economists from 40 to 80.

These increases may alleviate some of the problems we heard about. For example, one district was unable to supply detailed economic assistance on 14 of the 16 cases it believed needed the assistance. To develop adjustments using the arm's length standard, an examiner's normal accounting and legal expertise must be supplemented with an expertise in economics. Officials in another district told us that there was only one economist located in their region, and because of this district examiners often could not get an economist when they needed one. Examiners dropped many issues because they could not properly develop them without an economist, and the issues that were pursued and developed were often criticized in appeals or dismissed in court because the cases lacked sophisticated economic analyses. For example, in deciding where to apply examination resources, an IE manager told us he would favor issues that accountant IEs could handle rather than pursue section 482 issues that would require economic modeling that his IEs were not capable of doing.

Staffing expertise and experience. Beyond the question of the number of staff is the issue of staff abilities. For instance, a December 1989 internal IRS report on CEP, which was based on a review of 24 cases and interviews with about 100 people, touched on this issue. According to the report, even when revenue agents properly identified audit issues in spite

of the general problems of insufficient IRS technical guidance and the skill gap between revenue agents and practitioners, they often failed to factually develop cases, and appeals officials might have later been properly conceding them.

Many of IRS' IEs were relatively inexperienced due to hiring difficulties over the last decade. Because of various hiring freezes, IRS had fewer seasoned revenue agents from whom to recruit IEs. Moreover, many IEs gained their experience auditing tax shelters rather than corporate tax returns. IRS district officials told us of difficulties in handling section 482 cases because of the experience level of the IEs.

In analyzing recent training questionnaires sent to all IEs and their managers about the importance of, and performance error rates for, various tasks, IRS found that 80 percent of IEs believed that examining Form 5472[1] was of "high importance." However, according to IRS, a "very high" 21 percent of IE managers reported that their employees made substantial errors in completing the task satisfactorily. IRS noted that the degree of difficulty an IE had doing this task was probably a direct reflection of how long the individual had been an IE.

Twenty-four percent of IE managers answering the questionnaires believed their trained IEs made substantial errors in identifying section 482 issues. IRS determined that much more training emphasis should be placed on section 482 because inbound pricing issues were being assigned to new IEs.

In one case we analyzed involving a subsidiary that IRS believed was paying too much for goods received from its parent, the examination was assigned to an IE who had just completed introductory international training. The IE told us that it was difficult to determine how to develop the case and that this was particularly a problem in a specialized area like transfer pricing. As a result of this and other reasons, the case was not fully developed, making it vulnerable to challenge by the taxpayer. According to an IRS attorney, industry statistics used in the examination were too broad.

In another district, an appeals officer told us that no economist had been assigned during the examination phase to a case we were studying. The IE

[1]Form 5472, discussed later in this chapter, is the information form that domestic corporations meeting certain foreign ownership requirements must submit with their income tax returns. It lays out the dollar value of intercompany trading and is considered an indicator of possible transfer pricing problems.

for this case had to perform the economic analysis. While the case was in appeals, an economist was assigned, but the attorney did not have faith in that economist's analysis and chose to hire an outside economist. For this and other reasons, the case was not fully developed and IRS' ability to get the most taxes possible from this case may have been compromised.

Low pay. National Office officials and district personnel suggested that IRS had difficulty recruiting and retaining economists and IEs because of noncompetitive salaries. In this context, one district cited a turnover rate for economists of 70 percent over 3 years, and district officials told us that although they had IE slots authorized to be filled, they preferred leaving them empty to hiring individuals willing to accept IRS salaries but who were not well qualified for the job.

The gap between civil service and private industry pay for comparable jobs was especially a concern in high cost-of-living areas. For example, according to the April 1990 Los Angeles Federal Executive Board Salary Report Update, the overall pay gap between federal and private sector employees in Los Angeles was 40 percent. However, for an Internal Revenue agent/appeals officer, the pay gap ranged from 57 percent to 82 percent, depending on the grade level of the employee. (The gap closed as the grade level increased.)

In 1990, Congress passed legislation that resulted in raising federal salaries by 8 percent in three high cost-of-living areas. In addition, IRS has received permission to pay special salary rates to revenue agents hired in grade levels 5 through 11 in 18 other geographic areas.

The IRS Commissioner testified before the House Appropriations Committee in March 1991 that the recently passed locality-based pay program had helped IRS' hiring situation. However, locality-based pay initiatives clearly do not in the short term eliminate pay disparities like the Los Angeles situation described previously, and it is too soon to determine if the pay increases were large enough to overcome IRS' problems in hiring and retaining staff.

Meanwhile, IRS was studying the recruitment, training, and retention of its international issues workforce. This study had been in progress for about 3 years, and a report was being drafted during our review.

No optimal staffing system. According to IRS officials and a recent internal IRS report on its international efforts,[2] the Assistant Commissioner (International) had yet to develop an optimal workload planning and staffing system applicable nationwide. According to the report, there was no staffing model that could be used by the Assistant Commissioner (International) and the Assistant Commissioner (Examination) to determine whether the number of IEs and economists should be increased, and the districts analyzed for the report had no consistent method for determining staffing needs, particularly for non-CEP cases. IRS officials told us that IRS allocated the recent staffing increases described above on the basis of an informal survey of the regions' staffing needs. No systematic study of workload and staffing needs was done.

The last informal survey of regions' international needs was 5 years ago for an issue that never materialized as a focus of IRS exams. Even though the issue never materialized, staff slots were allocated to a particular district. The district used the slots to begin examining FCCs but, because of pay considerations, was never able to fill all of them. The district operated at 84 percent of its international examination capacity for 6 years and, therefore, often had unfilled slots before IRS decided that it could use 100 more IEs overall. Presumably, IRS could have used the unfilled positions in other locations.

The 1988 annual business plan issued by the Assistant Commissioner (Examination) required the regions to study their staffing in order to adequately allocate examination resources in the international area. However, IRS' international oversight reports were able to praise only specific regions for doing such workload and staffing studies and criticized others for not doing them.

During our review, IRS expressed its desire to develop a nationwide system showing which international tax returns needed to have an international examiner assigned to them. In this way, IRS hoped to get a better fix on its international workload and on its staffing needs.

[2]The report, published in July 1991, resulted from a 1988 IRS concern that it could not effectively identify and address noncompliance with international tax laws, could not define and measure compliance effectiveness, and did not have a realistic model to determine appropriate international staffing levels.

Delays in Receiving Taxpayer Information Cited as Critical Problem

Both our 1981 report and Treasury's 1988 White Paper stated that access to pricing information was a significant problem. According to the White Paper, in some cases relevant information was not furnished by the taxpayer to the examiner, and in other cases agents experienced long delays in receiving information. The vast majority of taxpayers were unable to explain how their intercompany pricing was established.

Timely access to records was a problem in inbound cases because the information was typically held by the foreign parent of the controlled entity. According to IRS officials and the White Paper, foreign parents, which were not subject to information reporting requirements similar to those for U.S. corporations, often refused to produce pricing information upon request.

For example, in one case involving excess interest rates being paid to an affiliate an IRS official told us that the parent company and its U.S. subsidiary were uncooperative in providing information; they would not even provide a complete organization chart when asked. Although the IE used a summons in this case, IRS still did not receive information it considered adequate for its needs. The IE had difficulty getting enough information from the company to determine exactly what additional information to request in a summons. We were told that the major issue in the case might not have been developed if IRS had not been able on its own to establish an undisclosed link between two companies.

IRS' emphasis on quickly closing large cases exacerbated the access-to-records problem. According to the White Paper, section 482 cases were closed without IRS receiving necessary information or having the opportunity to follow up on information that had been provided. The December 1989 report on CEP found that large case development in general was hindered by IRS' inability to efficiently audit within certain time constraints. Thus, if taxpayers were slow to provide IRS with the right information or any information at all, their delaying tactics would benefit them when IRS ran out of time to do its examinations.

Legislation. In 1989 and 1990, record-keeping legislation was passed to alleviate the information access problem. Under the new legislation, any domestic corporation that is at least 25 percent foreign-owned must keep books and records relating to transactions with foreign-related parties and must annually report those transactions to IRS. The foreign parties must also authorize domestic corporations to be their agents for accepting IRS requests or summonses for their records. Companies not complying with

these rules are subject to substantial monetary penalties. While some interested parties believe the legislation will go a long way toward eliminating the problem, others are skeptical about the usefulness of such access for two reasons: (1) the continued need to assimilate the information and apply it to cases that would still be factually unique and complex and (2) previous experiences with summonses.

Summonses. Before the recent legislation, examiners had more limited authority to issue summonses and formal document requests for information they determined was critical to discovering an arm's length transfer price. As the White Paper and the internal report on CEP stated, they failed to use these limited procedures aggressively. According to documents we reviewed, IRS regions varied widely in how often they used summonses, with only two using them in significant numbers.

Two common reasons for the reluctance to use summonses were cited in the White Paper. The first was that time delays examiners experienced following up on summonses conflicted with IRS' need to close examinations quickly. The second was the need to maintain good working relationships with taxpayers, which IEs feared would be harmed if the procedures were used.

Future. It is too soon to tell whether IRS' past emphasis on quick turnaround and good relations with taxpayers will continue and prevent examiners from effectively using the new record-keeping legislation. We do know that IRS has implemented an initiative to try to resolve CEP cases earlier than before through increased management attention and new procedures. Also, the record-keeping regulations recently published may strain the relationship between taxpayers and IRS by allowing IRS to ask for documents that taxpayers consider too burdensome to produce and maintain.

Also, to keep the administrative burden on corporations down, the regulations exempt FCCs with less than $10 million in annual U.S. gross receipts from certain aspects of the record-keeping requirements; but they still must file information returns with IRS. This exemption could affect over 90 percent of FCCs—about 35,000 of those corporations that say they are foreign controlled—accounting for about 4 percent, or $30 billion, of FCC sales in 1988.[3] The exemption obviously reduces the overall record-keeping burden on small corporations, but IRS data on corporate

[3]These sales numbers could actually be lower because, for example, to meet the $10 million test, the gross receipts of all related corporations reporting to IRS on Form 5472 must be aggregated.

income tax compliance show that small companies in general (in this case, those with less than $10 million in assets) voluntarily paid only 61 percent of the taxes they owed for tax year 1987, down from 81 percent in tax year 1980. IRS did not analyze statistics for small FCCs separately.

IRS' Use of Management Information Was Still in Its Early Stages

Although IRS had recently begun a number of new management information initiatives, in general it was still in the process of defining the scope of the inbound transfer pricing problem and developing the information tools to manage it. In our 1981 report on U.S. multinational corporations' transfer pricing, we pointed out many of IRS' section 482 information deficiencies. To a large extent, similar FCC information needs have not yet been met.

Information on noncompliance trends, intercompany transactions, and fragmented companies. Our 1981 report discussed extensively IRS' need for more management information to measure its enforcement of section 482. For example, IRS needed (1) to know the incidence and magnitude of MNC noncompliance to allocate resources properly, (2) to accumulate and analyze section 482 information from a management perspective, (3) to know the extent to which FCCs did intercompany business, and (4) to know and use information on the universe of multinational corporations and the location of their worldwide operations.

The recent internal study of IRS' international operations pointed out that the Office of the Assistant Commissioner (International) had still not done a systematic analysis of overall noncompliance trends to be able to best use its IEs. We noted that IRS was just beginning to explore the extent of noncompliance in medium- and smaller-sized companies.

IRS has not systematically analyzed section 482 information from a management perspective in spite of reporting in 1984 that such information would help it better plan, manage, and assess its international enforcement efforts. Based on questionnaires sent to IEs, IRS' 1984 report developed data identifying frequency, trends, and types of section 482 adjustments; geographic areas of noncompliance; and profiles of businesses most likely to be susceptible to improper shifting of income. Using examinations completed in 1980 and 1981, the report showed recommended section 482 adjustments of about $4.4 billion, with about 63 percent of the recommended dollars involving entities located in tax havens or other nontreaty foreign countries. The $4.4 billion was almost seven times higher than the amount in a 1973 IRS survey.

After our 1981 report was issued, IRS began collecting Forms 5472 from FCCs. These are the information returns on which FCCs report information to IRS on the value of intercompany transactions and on the countries and industries involved. Because outbound transactions had been IRS' transfer pricing focus, IRS began computerizing Form 5472 information for analysis only recently. However, the 1991 internal report on IRS' international operations found that Form 5472 information was not always reported, timely, or well used. In addition, an IRS official told us that all possible uses of the information collected on these forms had not been thought through yet.

In August 1990, IRS finished compiling a database to identify and aggregate tax information from smaller corporations in different parts of the country that were controlled by the same party but individually may have been overlooked for examination because of their small size. IRS had been planning for a database linking parents and subsidiaries since the early 1970s. The database lists foreign-controlled firms according to common ownership of stock. As noted in chapter 2, IRS planned to use this information to examine fragmented operations of FCCs.

Data on IRS examination findings and results. IRS designed a system to capture data on proposed international adjustments to income by Internal Revenue Code section. For example, the system contained the names of taxpayers with proposed section 482 adjustments; the amounts of the adjustments, foreign tax credits, and penalties involved; and other Code sections that IRS cited when it examined those taxpayers. But IRS only began capturing these data in 1989, and an IRS official told us that the information was put to little internal use in terms of planning resource allocation. Also, as mentioned in chapter 2, the system capturing the information did not provide consistent or comprehensive data. Use of the system was minimized by 1990 data entry being stopped, and a new system was to be used in 1992.

IRS did not have a system tracking the extent to which proposed adjustments, including international adjustments, survived various challenges and resulted in actual tax collections. As IRS noted in a 1989 study, and as we reported as far back as 1982 and again in 1990,[4] each enforcement function in IRS had its own management information system. These systems were generally incompatible with one another and did not track cases across functional lines. Just as in other areas across IRS, this

[4] Further Research Into Noncompliance Is Needed to Reduce Growing Tax Losses (GAO/GGD-82-34, July 23, 1982); and Tax Administration: IRS Needs More Reliable Information on Enforcement Revenues (GAO/GGD-90-85, June 20, 1990).

was not a new issue in the section 482 area. Responding to a draft of our 1981 report on transfer pricing, IRS said it was developing a project proposal to link section 482 information coming from the examination, appeals, litigation, and competent authority functions.

IRS was planning an agencywide system to eliminate these cross-functional problems and begin producing meaningful data in 1992. The system is to track examination results until they are resolved and measure enforcement revenues and costs by case. IRS hopes that this system will help it better judge the success of its major enforcement efforts.

In response to the 1990 transfer pricing hearings, the Assistant Commissioner (International) was planning a linking system specifically for section 482 cases. The system was intended to provide section 482 litigation and appeals information to the Assistant Commissioner (International) and CEP.

Other information initiatives. IRS has acknowledged that it could use better data in the international area. To achieve this goal, the Assistant Commissioner (International) in 1991 established a new International Compliance Analysis Division. This division is responsible for workload identification and trend analysis research. IRS expects this division to produce valued guidance on how and where it should direct its resources in order to best respond to Congress' concerns about FCC tax avoidance.

In addition, the information system used by appeals for section 482 and other issues has already been refined. For instance, in late 1990 appeals began capturing section 482 cases by type of section 482 issue, such as interest on an intercompany loan or marketing services performed for a related party, so appeals officers handling the more than 200 section 482 work units in appeals could be more familiar with what each other was doing.

Examination Findings Were Often Not Sustained in Appeals or Litigation, or Handled Quickly in Competent Authority

Appeals. Over time, a steadily larger percentage of IRS examiners' proposed dollar adjustments were presented to IRS' appeals process for all types of issues examined. The percentage rose dramatically between 1977 and 1989 from 47 percent to 80 percent, an increase attributed mainly to large cases—those with taxpayers receiving a proposed adjustment of $1 million or more. As of September 1991, large cases represented only about 4.6 percent of appeals' total case inventory but represented 92.2 percent of the dollars appealed.

During 1989 and 1990, appeals sustained 43 and 44 percent of all total large case issues and conceded $12 and $20.8 billion in proposed adjustments, respectively. The 1989 IRS CEP report called low sustentions unacceptable. Consequently, an overall CEP goal was to improve the sustention rate by, among other things, establishing a new organizational structure, strengthening management controls and accountability, and coordinating the hiring of outside experts to help resolve complicated cases.

As described with qualifiers in chapter 2, the sustention rate for transfer pricing issues for 1987 through 1989 was 29.8 percent, a level that an appeals official called conservative. As we also noted in chapter 2, however, seven of the eight FCCs with the largest proposed section 482 adjustments had sustention rates lower than 15 percent. The section 482 sustention rates for cases closed in 1989 and 1990 were 37 and 52 percent, respectively.

In an effort aimed much more broadly than at just section 482, IRS was studying its sustention rates in appeals and litigation by capturing information on the reasons for low rates in order to improve the rates. Examples of reasons were new facts or evidence coming to light or the examiner misjudging or misapplying the facts or the law related to the appeal.

IRS was also studying recovery rates, or the percentage of taxes and penalties actually recovered once amounts were settled in appeals. Recovery rates are different from sustention rates because, for instance, net operating losses can affect recovery amounts.

According to two recent internal IRS studies, there were two main problems between the examination and appeals functions that prevented sustention of examiners' proposed adjustments to income. First, according to the internal 1989 IRS report on CEP, cases were poorly developed when they entered the appeals process, and appeals might have been properly conceding them. According to the 1991 internal report on IRS' international programs, international cases suffered from inadequate factual development; the failure of IEs to use administrative summonses, outside experts, and counsel; and other problems.

According to the internal IRS reports, the second factor working against sustention of adjustments was poor communication and a feeling of mistrust between IEs and appeals officers. Mistrust resulted from the view that taxpayers had complete access to appeals to present additional

documents and arguments, but contact between IEs and appeals officers was limited. The report on CEP also mentioned a perception that appeals judgments lacked consistency. In CEP, IRS was working to overcome problems by having case meetings between examiners and appeals officials both before and after appeals conferences with taxpayers. Also, examination case managers have been given authority to settle issues previously resolved by the appeals function with a particular taxpayer that recur or that have a continuing effect in later years.

Litigation. IRS testified in 1990 that only 3 of the 20 major transfer pricing cases that had been decided in court since 1964 were inbound,[5] and IRS lost all 3—1 in 1973 and 2 in 1985. According to IRS, the court rulings hinged on the evidence and testimony offered at trial. IRS contended that the three cases contained issues different from those coming to the fore more recently.

Even today, however, transfer pricing cases in general can be very burdensome, time-consuming, and expensive for the courts, IRS, and the companies involved. According to the Chief Judge of the United States Tax Court, transfer pricing cases have absorbed a substantial part of the Court's pretrial, trial, and posttrial resources. A Court of Claims judge cited similar problems in 1978 and stated that the regulatory structure was wholly inadequate and that a more manageable and expeditious means of resolution should be found.

IRS believed that the way section 482 cases were developed and the difficulty IRS had procuring expert witnesses to testify hampered its ability to litigate section 482 cases successfully. According to IRS attorneys in one district, some cases for which taxpayers received notices of additional tax assessments were only minimally developed. In order to proceed with the cases, the IRS attorneys had to try to develop them themselves by retaining expert witnesses and searching for comparable prices that were not previously developed.

Recently, IRS has emphasized getting counsel representatives involved earlier in cases than they had been previously. The purpose of early involvement is to make sure that inappropriate issues are dropped early, saving the taxpayer and the government money and frustration, and appropriate issues are developed so they can be sustained later. The Office of Chief Counsel has designed a Field Service Unit to ease communication

[5]As alluded to in chapter 1, inbound cases cover the prices a foreign parent corporation charges its controlled U.S. entity.

between IEs and their district counsels and to improve IE and district counsel training on international issues.

Also, IRS received legislative authority to circumvent the previously cumbersome procurement process for hiring expert witnesses to participate in cases and testify at trials. IRS needs more experience with these new procedures to see if they increase its effectiveness in dealing with section 482 cases.

Competent authority. According to a mid-1980s internal IRS study of competent authority and according to competent authority officials, the main problem with the competent authority process was it was taking too long to resolve cases. Most of the allocation of income cases that entered competent authority were transfer pricing cases, and resolutions of cases in fiscal year 1990 averaged about 2 years if the cases originated outside the United States and about 5 years if they originated domestically. IRS was again studying the competent authority process, and the 1991 plan of the Assistant Commissioner (International) alluded to the need to improve program quality and effectiveness and to reduce case processing time by 5 percent. The average U.S.-initiated competent authority case closed in fiscal year 1991 took 3.8 years, and the average foreign-initiated case took 2.4 years.

National Commitment to Transfer Pricing Related to FCCs Evolving but Requires More Central Activity

Lag in commitment to transfer pricing related to FCCs. As noted in chapter 1, foreign direct investment in the United States increased dramatically during the 1980s, from about $83 billion in 1980 to about $401 billion in 1989. In 1989, it actually surpassed the amount of direct investment abroad by U.S. multinationals. However, as a former Assistant Commissioner (International) wrote in 1988, IRS did not adjust quickly to this change.[6] The expertise IRS developed in FCC transfer pricing cases lagged behind its expertise involving U.S. multinational corporation cases. Further, as mentioned earlier, access to data held by foreign parent companies posed additional difficulties and, as described below, conflicting priorities affected the attention devoted to all transfer pricing cases, including those covering FCCs.

In one FCC case we studied, the IE told us that the field personnel did not have the support of IRS' National Office in developing a section 482 issue. The National Office, we were told by a district official, pressured local officials to move the case along because it was taking so much time.

[6] Percy P. Woodard, "The IRS Redirects Its International Program," Tax Notes (Oct. 24, 1988), page 455.

Pricing issues had traditionally not been raised for taxpayers in that industry, and management was reluctant to become involved in such a difficult case. Still, the IE pursued the section 482 issue, and a proposed adjustment was later partially sustained.

Commitment to transfer pricing examinations faced conflicting priorities. IRS did not examine more cases, and particularly more FCCs, for transfer pricing issues because of conflicting priorities, some of which were pointed out in the White Paper. For example, because IRS emphasized short-term revenue gains and the desire to meet certain productivity goals, the focus was on quickly closing large cases. According to Treasury's White Paper, this goal caused section 482 cases to be closed without the examiner obtaining or following up all the information needed to properly develop them.

In addition, the productivity measures IRS used to calculate the benefits and trade-offs of its examinations worked against long-term IRS investment in transfer pricing cases. IRS measured productivity by associating efficiency (in hours per return) with effectiveness (in dollars per return) to indicate overall productivity of regions in (dollars per hour).

Because of productivity disincentives, examiners did not focus their attention on FCCs with net operating losses and, thus, may have missed some potential transfer pricing cases. Because any proposed adjustments increasing a company's income could be negated if the company carried a net operating loss forward or backward, spending resources examining the company would not yield IRS immediate revenue. Examiners working within the productivity framework emphasizing dollars per hour and dollars per return did not receive credit for lowering net operating losses even though these reductions could eventually increase IRS' future revenue. This was the case even though having large net operating losses could be one characteristic of corporations that manipulate transfer prices. The presence of net operating losses could affect examinations of FCCs more than examinations of U.S.-controlled companies because, as shown in chapter 2, a higher percentage of FCCs were unprofitable in any year. For example, an IRS official told us that on one case he did not plan to spend significant resources because there would be no positive cash flow coming from the case. The taxpayer would be able to carry forward large net operating losses from previous years that would offset any additional taxes due.

Officials in one district told us that, in general, the district had not examined many FCCs in the past because the FCCs had significant losses from year to year. They said that even though there were potential issues with these cases, examining them would likely result in only minimal revenue to IRS.

IRS acknowledged that focusing attention on section 482 required examiners to take risks given the noted productivity measures, and it commended one region for taking such risks and examining non-CEP cases for which no adjustments might be recommended. Similarly, an internal report noted that relying only on traditional yield measures inhibited risk-taking needed for developing new issues and prevented devoting enough time to getting the facts needed to make sound adjustments in examinations.

IRS did not consider it cost effective to devote scarce resources to small cases with relatively little potential for revenue generation. IRS officials said that small transfer pricing cases are just as factually unique and difficult to develop as large transfer pricing cases. IRS, therefore, concentrated its examination efforts on large FCCs.

However, small corporations may collectively represent a significant compliance problem, and the fragmented operations of a large multinational corporation, when taken together, may become a case large enough to be placed in the CEP. As mentioned earlier, IRS had recognized this possibility and had begun to focus on smaller FCCs, some of which are fragments of larger ones.

Growing commitment and recent centralized and decentralized initiatives. Since the mid-1980s, both the National Office and various district offices have initiated various programs to deal more effectively with transfer pricing cases. While these initiatives are a start, some have been more effective than others, and IRS would benefit from having more centralized activity regarding transfer pricing issues.

For example, according to an IRS official, the Field Assistance and Support Team within the Office of the Assistant Commissioner (International), originally designed in 1986 as the Transfer Pricing Team, was intended to stress inbound transfer pricing issues through the coordination and monitoring of section 482 issues on a nationwide basis. However, he added, the nature of the workload within the group made concentration on the technical aspects of transfer pricing alone impossible. The group had

to become involved with related matters, such as organizational issues, record-keeping legislation, and relations with Congress and foreign governments. So while the group continued to work on section 482 issues, section 482 cases were not its sole mandate.

For tax returns filed in 1987 and 1989, IRS for the first time formally segregated FCC information on receipts, income, and taxes from other corporate information for planning purposes. However, the planning was local; regions and districts were sent, and given the responsibility for analyzing, their own FCC data. Officials in one district we visited told us that they had not yet analyzed the FCC data for their district. IRS did not use the information for determining, on a nationwide basis, which districts needed what resources based on the magnitude of those districts' potential transfer pricing problems.

One district pioneered an effort within IRS and started a project on FCC, non-CEP cases in the late 1980s. The number of cases in the project has more than doubled since its inception, but the results have not been continually fruitful to date. This was due, in part, to the staffing problems described earlier and the fact that the cases that are the hardest from IRS' standpoint take the longest to complete.

At about the same time, another district proposed forming a section 482 group to focus on resolving transfer pricing cases. However, again because of personnel shortages, the formation of the group was delayed, and it only became operational in early 1991.

On a larger scale, recent IRS efforts have recognized that IRS' traditionally decentralized approach needs to be changed where comprehensive examinations of commonly controlled FCCs are concerned. Because of the complexity of these examinations, the overlapping jurisdictions involved, and the concern that participating districts might not get the credit they would get if they were leading their own examinations, IRS started a program aimed at more centralized oversight of wide-ranging examinations. This should enable IRS to better examine section 482 and other issues affecting both domestic companies and FCCs, such as the FCC, cited in the internal IRS report on CEP, with 19 subsidiaries filing in 15 separate districts.

More proactive, centralized section 482 activity is important. As a result of its study of international programs, IRS is instituting, on a test basis, an International Field Assistance Specialization Program to enhance

its ability to develop quality, sustainable international tax issues. The program consists of a national administrator and experienced IEs who are to act as consultants in their areas of expertise. It has two experts on section 482 issues—one inbound and one outbound—to provide section 482 guidance to other IEs throughout the country.

IRS also established an electronic bulletin board to provide IEs listings of other IEs working on similar issues they may contact for information and advice. The system is to provide IRS employees with a way of exchanging information, knowledge, and ideas regarding international taxation issues.

Although these new systems are definitely steps in the direction of sustaining an IRS commitment to focusing on transfer pricing, we believe that they could be further enhanced. For example, the specialist program could help ensure that all the various IRS information initiatives that have been and are being taken—the FCC data tapes, the fragmentation database, the pursuit of small-and medium-sized examinations, the new trend analysis group, and the analysis of the Form 5472 intercompany transaction information returns—are continually examined with an eye toward section 482 specifically and information needs generally.

As these efforts provide a better picture of the scope of the section 482 problem, the section 482 specialists and/or their administrator could help ensure that the correct number of IEs and other personnel are assigned to the problem. They could also be sources of information nationwide so less reliance might have to be placed on local initiative than in the past. In addition to passing on section 482 information from the various data analyses, the specialists and/or their administrator could provide specialized help—such as helping analyze local FCC tapes—on section 482 issues.

Specialists in section 482 and/or their administrator could also be in a better position than anyone else to assess the impact on section 482 issues of conflicting priorities. They could have the responsibility on a national level of assessing the implications of priorities encouraging that cases be closed quickly or the impact of a practice causing corporations with net operating losses to be ignored because of a need for short-term revenue.

Specialists and/or their administrator might also be in a better position than anyone else to ensure that section 482 issues are being properly addressed in comprehensive examinations of commonly controlled FCCs.

The specialist program could help make sure that section 482 issues are properly pursued across jurisdictions.

Conclusions

The factors that we saw affecting IRS' ability to determine and recover taxes underpaid due to potentially improper transfer pricing were not new or unknown to IRS. Our 1981 report and the 1988 Treasury White Paper pointed out the difficulties of applying the section 482 regulations to factually unique cases, the challenge of accessing pricing information, and the deficiencies in IRS' section 482 management information systems. In addition, recent internal IRS studies—one on CEP and one on IRS' international operations—discussed difficulties in IRS' international staffing allocation system, shortcomings in management information, problems in sustaining examiners' findings, and the need for section 482 specialists.

IRS has taken some action in all of these areas and has many efforts under way. However, results are not yet available for determining the impact of such changes as redrafted section 482 regulations, pay increases for some IRS employees, the staffing needs determination system being contemplated, new record-keeping legislation, various management information initiatives, IRS studies of sustention rates and the competent authority process, and IRS' test of the idea of having section 482 specialists.

These changes notwithstanding, our recommendations further address the intertwined requirements for a staffing needs determination system, better use of management information, and a more centralized way of dealing with section 482. For example, IRS' intention to get a better fix on its international workload and on its attendant staffing needs is laudable. However, we believe a staffing system like this needs to be continually used so IRS does not have to resort once again to sporadically determining its resource needs and relying only on input from field locations.

IRS' efforts to develop various kinds of management information related to section 482 are also praiseworthy. However, given that there are so many efforts and that problems we cited in 1981 are still present, we believe IRS should take advantage of the newly formed International Compliance Analysis Division and formally plan coordination of its various projects. In this way, it can do more than it has in the past in studying trends in the types of section 482 findings, in intercompany transactions, and in section 482 case disposition. Once these trends are identified, IRS can use them to further improve compliance.

Finally, setting up section 482 specialists presents IRS with many opportunities. Given their large-scale involvement with section 482, these specialists, or their national administrator, would be in an ideal position to analyze from a section 482 perspective the information initiatives being taken. They could also help make sure that staffing allocation decisions properly and continually take international workload into account. Finally, they could assess the impact on section 482 of any conflicting priorities, such as those that encouraged that cases be closed quickly or that caused corporations with net operating losses to be ignored because of a need for short-term revenue, and raise for discussion any conflicts that persist.

Recommendations

We recommend that the IRS Commissioner

- develop an optimal workload planning and staffing system and continually use it to provide ongoing information at the national level for assessing international staffing needs to best meet the international workload;
- formally plan, possibly through IRS' new International Compliance Analysis Division, how IRS will put together all of its data to study trends in the types of section 482 findings, in intercompany transactions, and in section 482 case disposition, and how it will act on the trends to improve compliance once they are identified; and
- use IRS' new specialist program to monitor all section 482-related information initiatives being taken, be involved in periodically determining how many IRS staff are needed for section 482 issues, and raise for discussion policies that conflict with an ongoing emphasis on section 482.

Agency Comments and Our Evaluation

IRS commented that our recommendations in this chapter are consistent with efforts it has been undertaking for several years. It said that with recent developments, such as its new International Compliance Analysis Division and its new International Field Assistance Specialization Program, it had significantly improved its international compliance efforts. We agree that IRS is making significant improvements and that its overall effort is praiseworthy. In that regard, we note that IRS said it was already working on the matter covered by the first of our recommendations. In our view, however, IRS did not address the specifics of our other two recommendations.

Responding to our recommendation that IRS formally plan how it will put together all its data related to section 482, IRS described the role of its newly formed International Compliance Analysis Division. We are aware

of the new division and believe it strengthens IRS' international compliance efforts. In its comments, however, IRS did not specifically address whether the division would formally plan how to bring together all of IRS' diverse information efforts relating to section 482. Given how many efforts there are and given IRS' past history of experiencing difficulties in bringing information initiatives to fruition, we believe a formal plan coordinating its efforts is warranted. Such a plan would help IRS organize and use all the data available to it and provide a road map to help the new division carry out its duties of identifying multinational trends and pinpointing tax issues and market segments that might merit more examination coverage. We continue to believe that the new division would be the most logical unit to do the kind of planning we have recommended.

IRS responded to our third recommendation, on how section 482 specialists could be used, by describing the intentions of the specialist program. IRS said the program is designed to provide "how to" technical assistance, achieve IRS-wide consistency on tax issues, develop and disseminate audit techniques, consult on tax matters, and train others. We recognize that these are crucial goals for the program, but what our recommendation envisioned was that the specialists should also be involved in other matters related to section 482 issues.

We believe that section 482 expertise should be brought to bear in monitoring section 482-related information initiatives, helping determine section 482 staffing needs, and raising for discussion policies conflicting with an ongoing emphasis on section 482. In a meeting with the administrator of the specialist program and other IRS representatives, the IRS officials expressed their concern that the role we envisioned for the specialists would detract from their hands-on technical advisory role. Because the administrator is the link between the specialists and the rest of IRS, one of the officials suggested a better focus for our recommendation might be the administrator. We have accordingly modified our recommendation to discuss how the specialist program should be used, thus encompassing the specialists and/or their administrator.

Chapter 4

Alternatives for Dealing With Arm's Length Pricing Problems

Most major national taxing jurisdictions have agreed to the arm's length standard as the general approach for setting transfer prices. However, as chapter 3 showed, using the standard has resulted in extensive administrative and judicial disputes. This chapter shows that problems with arm's length pricing can be expected to continue and states advantages and disadvantages of widely different alternatives to the system that has been in place.

We believe several years will elapse before the effectiveness of the recent measures taken by Congress and the Treasury Department to combat transfer pricing problems becomes known. For instance, new transfer pricing regulations were just proposed in January 1992, and they are generally not to be effective until taxable years beginning after December 31, 1992. Until the effectiveness of adopted regulations is known, various alternatives are likely to be discussed in the international tax community for dealing with problems still perceived to exist with arm's length pricing. The specific alternatives that we analyze in this chapter are formulary apportionment, a minimum tax on assets, the business transfer tax, increased use of safe harbors, and expanded methods for allocating income among related parties. The last alternative has an important attribute in common with the proposed regulations—an emphasis on income indicators from different companies.

The alternatives we discuss should not be construed as being all-inclusive. We selected the alternatives for study because they illustrate the variety of alternatives possible to deal with transfer pricing problems. Each of the ideas has advantages and disadvantages. Table 4.1 summarizes arguments for and against each alternative we analyzed.

Table 4.1: Alternatives Evaluated According to Four Criteria

Alternatives	Administrability	Economic Efficiency
Formulary apportionment	Formulary simplifies income allocation and provides greater certainty for taxpayers; tax experts disagree about information requirements; need to identify unitary business introduces new complications.	Formulary may distort investment decisions and cause asset shifting across tax jurisdictions; evidence for asset shifting is inconclusive.
Minimum tax on assets	The tax may simplify IRS administration, but IRS would need to monitor financial statements as well as tax returns; the tax increases FCCs' administrative burden; there are no estimates of the cost of administering this tax; the tax would represent a major change in the country's tax structure.	The tax may distort investment decisions and cause asset shifting across tax jurisdictions (like formulary apportionment).
Business transfer tax	The tax eliminates transfer pricing problems on inbound transfers but not on outbound transfers; there are no reliable estimates of the costs of administering this tax; the tax would represent a major change in the country's tax structure.	The efficiency of the tax depends on the design, for example, whether a single rate and a comprehensive base are used.
Expanding safe harbors	Safe harbors simplify compliance and provide greater certainty for taxpayers; they ease IRS enforcement problems by limiting cases that require transfer pricing audits; however, safe harbors may be difficult for IRS to construct and adjust to changing economic conditions; safe harbors are viewed by IRS as revenue losers.	Efficiency depends on the type of safe harbor adopted: for example, formulary safe harbors may lead to asset shifting; an arbitrary safe harbor, one not based on objective factors, may discourage investment.
Expanding allocation methods	The methods may be simpler than the current case-by-case approach; methods require rules for age and industry classification of corporations; acquiring current data for computing industry norms may be difficult; methods may be arbitrary when applied to individual corporations.	The methods may distort investment by producing different tax rates in different industries; distortionary impact is limited by the rule for start-up companies.

(continued)

Alternatives	Income Measurement	Inernational Cooperation
Formulary apportionment	According to supporters, formulary better approximates the contribution of each affiliate to total corporate income; according to critics, formulary arbitrarily allocates and ignores country-specific factors.	International consensus is needed in order to avoid double taxation and increased burden on the competent authority process; consensus may be difficult to achieve because the arm's length standard is perceived to be the international standard and is included in tax treaties between the United States and other countries.
Minimum tax on assets	The tax is not an attempt to better measure income; its purpose is to insure that all profitable companies pay tax; if transfer pricing abuse is widespread, the tax may better reflect actual income.	The minimum tax may provoke retaliation by other countries if it is perceived as arbitrary and because it is not based on the arm's length standard incorporated in most bilateral tax treaties; the tax also violates the treaties if it is applied only to FCCs.
Business transfer tax	Since the tax is imposed on value added, not on income, the issue of income measurement does not arise.	Most industrialized countries use a destination principle, value-added tax, but most do not use the subtraction method business transfer tax; disputes may occur if exports and imports are viewed as valued less accurately under the subtraction method tax.
Expanding safe harbors	Safe harbors are not an attempt to better measure income; their purpose is to provide increased certainty and reduce administrative costs; IRS and the taxpayer sacrifice accuracy in reported income for lower costs and greater certainty.	Safe harbors should be coordinated with other countries; if other countries do not recognize U.S. safe harbors as compatible with tax treaties, U.S. taxpayers risk double taxation and IRS risks increased burden on the competent authority process.
Expanding allocation methods	The methods may adjust income to better reflect true income if the presumption is correct that companies subject to the tax have existed too long to pay little or no tax; companies with weak earnings may be overtaxed.	Other countries may retaliate or competent authority cases may increase if others view the methods as departing from arm's length; however, a German court does use absence of income as evidence of non-arm's length pricing; the methods may be viewed as discriminatory in violation of tax treaties if applied only to FCCs, but they could be defended as enforcement tools permitted by the treaties.

In this chapter, we also discuss the possible use of arbitration procedures for dealing with transfer pricing problems.

The Arm's Length Standard

As mentioned in chapter 1, the arm's length approach views intercompany transactions in terms of the pricing arrangements that would have been made between unrelated parties. If claimed intercompany prices differ from those that would have been charged by unrelated parties, IRS may increase or decrease them to reflect the arm's length value.

Arguments for Arm's Length Pricing

Based on transactions. The arm's length standard promotes income allocation based on transactions, not on arbitrary rules. Transfer prices, representing the cost to one party in the transaction and the revenue of another, are to be set according to the facts and circumstances of each transaction. Supporters of the arm's length standard contend that the standard is market based, i.e., the standard uses transactions that would occur in the marketplace as the norm and is, therefore, more acceptable to taxpayers and tax administrators than formulas that divide the overall income of the corporations regardless of how the marketplace would operate.

Does not distort decisions on the location of investment. The arm's length standard, when correctly applied, is geographically neutral. It does not cause income from investments abroad and in the United States to be taxed differently from each other. Therefore, it does not interfere with a multinational corporation's decisions to invest capital where it can be used most productively. Investment distortions may occur, however, if administering the standard is difficult and transfer pricing abuse is widespread. In that case, for example, investment outside the United States may be more attractive to U.S. multinational corporations because of the opportunity they perceive to reduce taxes by manipulating transfer prices.

Accepted as the international norm. Nearly every country has adopted the arm's length standard as the general principle governing transfer pricing. Both the United Nations and the Organization for Economic Cooperation and Development recommend its use. The United States first incorporated the arm's length standard into its transfer pricing regulations in 1935. The section 482 regulations adopted by the United States in 1968 were the first detailed articulation of the arm's length approach, and U.S. adoption of this method influenced other countries to adopt it as well. The

United States is obligated, under most of its bilateral tax treaties, to apply the arm's length standard to transactions by persons subject to its tax jurisdiction.

Although other countries expressed concerns to us about the implementation of the arm's length standard, they did not know the extent to which their nations had transfer pricing problems. A couple of countries did express anxiety about the potential extent. Further, according to a recent publication issued under the auspices of the Institute for International Economics, U.S. enforcement of transfer pricing laws might be stricter than that of most other countries, causing us to wonder if problems in other nations have just not been uncovered yet.[1]

If the full extent of the transfer pricing problem is not known, reaching a consensus among countries for changing the arm's length approach would be especially difficult. Time-consuming persuasion would be required since international cooperation would be needed. A unilateral change might be resisted by major U.S. trading partners and, therefore, could increase the likelihood of double taxation for U.S. corporations.

Less likely to result in double taxation. The current widespread use of the arm's length standard minimizes the threat of double taxation that can arise when countries use different methods for determining tax liability. If the United States departed from the arm's length standard and did not coordinate this change with its treaty partners, the number of double taxation cases might increase. These cases could add to the burden of a competent authority process that has been criticized as taking too long to resolve cases. Double taxation can still occur under the arm's length standard when a tax authority adjusts disputed transfer prices, and the dispute is not resolved among the competent authorities of the affected countries.

Problems Cited With the Way Arm's Length Pricing Has Been Done

Creates an administrative burden. As described in chapter 3, conforming to the existing regulations for determining transfer prices, which must be done on a case-by-case basis, can be a very complex task. The complexity arises from the lack of comparable arm's length prices and the need to examine in great detail the facts and circumstances of each case. The work involved in documenting and justifying the methods and

[1]Edward M. Graham and Paul R. Krugman, Foreign Direct Investment in the United States, Institute for International Economics (1991), p. 83.

data used to arrive at transfer prices for a large number of transactions can be extremely burdensome for both IRS and corporations.

Creates much uncertainty. Since in many cases no single arm's length price exists, any price the taxpayer sets may be vulnerable to IRS adjustment. The potential for such adjustments adds to the uncertainty of the business environment, leading to complaints of hindsight pricing, with taxpayers claiming that legitimate expectations about the tax consequences of past conduct are upset by IRS. The consequences for taxpayers can be severe since small changes in transfer prices can result in large increases in tax liability.

Does not reflect economic reality. According to many economists, the arm's length standard imposes uncertainty and administrative burden because the standard does not reflect economic reality. The related parties within a multinational corporation do not treat each other as separate entities and do not choose arm's length prices for their transfers. The costs and revenue from transfers within an integrated enterprise like the multinational corporation are so unlike those that occur between unrelated parties that the arm's length standard provides little guidance in setting transfer prices.

When different companies are part of the same multinational corporation, the multinational's increased size and centralized control can result in greater efficiencies and, therefore, greater cost savings than if the companies were still separate. The multinational corporation may be more efficient than separate companies in raising capital, obtaining quantity discounts, and advertising products, and it may save on costs through economies of scale.

Similarly, if companies are integrated into a multinational corporation rather than dealing at arm's length, they will be better able to protect the revenue they derive from intangible assets. For example, intangible assets that are licensed to independent parties are more at risk to lose value than if they were licensed to affiliates. An independent party may cause a loss of value in a product's brand name by providing fewer customer services than a related party would. It may also be less vigilant in keeping technology or trade secrets from the multinational corporation's competitors.

Transfer prices that incorporate these cost and revenue considerations of integrated companies will not be the same as the arm's length prices used

by independent corporations. The arm's length prices will not reflect the potential for cost savings or protected revenue from intercompany transactions in the integrated corporation. Opponents of the arm's length method argue that the cost savings or protected revenue is properly attributed to the integrated firm as a whole, and transfer prices should not be used to try to allocate them to separate parts of the firm.

Provides too much room for abuse. Because multinational corporations are integrated enterprises, transfers within them often involve nonstandardized products and intangible assets that do not have comparable arm's length counterparts that can be readily identified. Even for tangible assets, our 1981 report found that only 15 percent of IRS' total recommended section 482 adjustments (representing 2 percent of total dollar value) used the comparable price method while "fourth methods" were used in 47 percent of all adjustments (representing 86 percent of total dollar value).

Opportunities for manipulating transfer prices exist because the lack of comparable transactions may make successfully challenging or defending prices difficult. In several major cases involving transfers of intangible assets, the court rejected IRS and taxpayer prices in favor of its own fourth method profit split while providing no consistent explanation of how it determined the division of income between parent and subsidiary. The term "fourth method" has been used to describe any method not specifically described in the regulations that, for tangible assets, could be used when comparable prices could not be found by either the comparable uncontrolled price, resale price, or cost plus method. These cases have been seen by some as evidence of the difficulty IRS faces defending its estimates of appropriate transfer prices in the absence of comparable uncontrolled prices.

Problems Will Continue

Despite all these problems, Treasury's and IRS' position is that the arm's length standard is better than any alternative that has been proposed and that it can be made to work. We believe the many initiatives being taken, including the staffing and FCC record-keeping changes described in chapter 3 and penalties for substantial section 482 adjustments, are steps in the right direction. However, we also believe that several factors will cause major problems to persist.

Globalization of trade. The multinational corporation, through its affiliates in different countries, arranges its operations on a global scale

and has come, therefore, to play an important role in international trade. At different times in the 1980s, intercompany trade (in this case, trade among affiliated domestic and foreign corporations) accounted for nearly one-third of world manufacturing trade and about one-quarter of total world trade. For the United States in 1986, trade among affiliated domestic and foreign corporations accounted for 38 percent of total U.S. exports and imports.

Not only is the volume of intercompany trade large, but so is the share of intermediate and high-technology products in world trade. Intra-industry specialization between component manufacturing and assembly of final products has increased the number of intermediate goods in world trade.

World trade has been shifting out of low-technology goods into high-technology goods. The share of high-technology goods in world export of manufactured goods rose from 14 percent in 1966 to 22 percent in 1986.

High-technology goods tend to be produced using intangibles such as patents that are unique to the multinational corporation. Intermediate products are often peculiar to the production and distribution processes of particular multinationals. Transfers of these goods, therefore, are unlikely to have comparable transactions, and determining appropriate arm's length prices will be difficult. If the trends toward increased world trade and increased trade in high-technology and intermediate goods continue, as they are expected to, transfer pricing in the future will continue to be challenging.

The increased volume of intercompany transfers that has accompanied the surge of foreign direct investment in the United States has increased IRS' enforcement burden. In one of the cases we analyzed, the IE told us that although in the past IRS had successfully adjusted the taxpayer's income because of transfer pricing abuse regarding a particular product, he was concerned that time and resources did not allow him to now also examine other products of the taxpayer for similar abuse. He was the only IE assigned to this company as well as to two other similar companies, and he said he would like to have spent more time examining the transfer pricing of various imported parts.

Problem's factual nature. In spite of FCCs being required to supply more information to IRS than they had to in the past, and in spite of Treasury regulations being revised to provide guidance for dealing with intangible

assets, determination of proper arm's length prices will continue to be difficult to enforce. Cases will still be unique and complex in that the proposed regulations require that the facts and circumstances of the case in question be considered in doing certain analyses. Assuming that in the future IRS receives timely information it did not get in the past, someone will still have to understand it, analyze it, and determine if it is compatible with the transfer prices that have been set. Former IRS Commissioner Egger has said that given each case's uniqueness, dramatically increasing IRS' examination resources will not solve section 482 issues.

Increasing caseload. The tax system may have increasing trouble handling section 482 cases. Public and private officials have voiced concern about years of section 482 litigation in store and about the surge in section 482 cases going to the Tax Court. Others have warned about the increasing number of cases and resulting burden on the competent authority process. The extent to which the appeals process will be able to handle the larger dollar amounts it receives is unknown.

The problem of intangible assets. Because intangibles such as patents, designs, brand names, and trademarks are often specific to a firm, the arm's length standard has been difficult to apply to them. The White Paper acknowledged that since intangibles typically involve unique property, comparable unrelated party licensees will often not be available for setting arm's length royalties for transferring intangibles to unrelated parties.

The proposed Treasury regulations on section 482 focus on transfer pricing for intangibles. As will be described later in this chapter, the proposal outlines an approach to dealing with intangibles that encompasses far-reaching changes to the way transfers have been handled. Treasury is to receive comments on the proposed regulations until July 28, 1992. Until the new regulations are published in final form and are in effect for a while, the extent to which the intangibles controversy has been resolved will be unknown. Moreover, if IRS and Treasury experiment with proposed regulations before finalizing them, the regulations' publication date will obviously be deferred.

Obstacles confronting advance pricing agreements. IRS recently began promoting and testing advance pricing agreements as a way of adding certainty to the transfer pricing process and reducing protracted debate about the facts of a case. In these agreements, a taxpayer asks IRS to approve ahead of time the methodology it will use when it sets transfer prices. In similar arrangements in the past, General Motors initiated and

secured agreements with 16 European countries to reduce the likelihood of transfer pricing controversies confronting the corporation in Europe. The advance pricing agreement will generally apply for up to 3 years and, during this period, will provide increased certainty to the taxpayer that IRS will not adjust its transfer prices.

The taxpayer holding an advance pricing agreement may be audited, but the transfer pricing part of the audit will focus on whether the taxpayer is setting prices in accordance with the agreement. The procedure is intended to reduce the amount of time IRS spends reviewing the pricing of companies with agreements and to free up IRS resources to audit other companies.

IRS hopes that the pricing agreements it negotiates will provide information about prices, markups, and profit margins that can be used for comparable transfers in cases where there are no agreements. For the cases where there are agreements, the hope is that the atmosphere between the taxpayer and IRS will be less contentious than in the past, transfer pricing problems will be resolved before they grow troublesome, and examination resources will be available for other cases. Several years will have to elapse, however, before the extent of these benefits becomes evident.

Nevertheless, advance pricing agreements may be successful for companies with potentially large transfer pricing problems. The relatively small number of companies with the resources to pursue an agreement are also likely to be the companies that would have the largest amounts in dispute if their prices were challenged by IRS. Even though fully successful advance pricing agreements will not solve all the problems of the existing transfer pricing system, by providing increased certainty for the taxpayer and IRS, they do represent a step in the right direction.

We believe, however, that the agreements may not be as widely effective as hoped in attacking transfer pricing problems. One reason is that they may be self-selecting—those taxpayers likely to be making good faith compliance efforts are most likely to use the voluntary process. Because of the extensive disclosure of information to IRS required to obtain an agreement, taxpayers inclined to manipulate transfer prices to reduce taxes may not seek such agreements.

A second reason is that because of the costs of obtaining an advance pricing agreement, agreements for only a relatively small number of companies can be pursued. Each agreement requires much information

and a large commitment of resources from both the taxpayer and the government. This commitment is needed because of the prospective nature of the agreement: many contingencies must be considered if neither party is to risk being disadvantaged by future events. If future events warrant, the parties may amend the agreement, IRS may cancel it, or the taxpayer may cancel it with the consent of IRS. Thus, IRS resources may be needed in any case.

If early advance pricing agreements are successful, another resource problem may appear. IRS may be inundated by corporations seeking the agreements.

Past and Present Consideration of Alternatives

Altering the arm's length approach has been suggested repeatedly. Our 1981 report, for example, concluded that options for adjusting the approach should be considered because the courts and tax experts had criticized it and because few comparable transactions existed. Because we believe that transfer pricing problems will continue, we believe that alternatives to the way transfer pricing issues are handled should continue to be explored. In the remainder of this chapter, we evaluate various alternatives using specific criteria based on accepted principles of taxation.

Framework for Evaluating Alternatives

We have chosen to evaluate, where appropriate, each alternative according to its impact on (1) administrative burden, (2) economic efficiency, (3) income measurement, and (4) international cooperation. These criteria are intended to identify key policy issues involving transfer prices and to show how the alternatives address them. We also discuss the revenue impact of the alternatives although revenue is not proposed as a separate criterion.

Administrability. Do the changes reduce the enforcement and compliance costs of the rules governing the division of income between parent and subsidiary? Administrative burden for taxpayers reflects the time and resources necessary to collect the information needed to comply with the rules and to feel certain that their efforts will withstand IRS scrutiny. The burden for IRS is the time and resources needed to ensure compliance and, where necessary, eliminate double taxation. Administrative costs should not be excessive when compared with the revenue produced.

Economic efficiency. Do the proposed changes interfere with economic decisionmaking? Tax rules should not cause unintended differences in the tax consequences of doing business at home or abroad. The tax rules should not cause corporations doing business in the same market to be taxed at different rates. Nor should the rules cause corporations to make investment or employment decisions they would not have made otherwise.

Income measurement. Does each alternative produce an accurate measurement of taxable income? Section 482 authorizes the Secretary of the Treasury to allocate income and deductions to reflect income and prevent tax evasion. The alternatives will be evaluated on the degree to which they produce accurate income and expense allocations for multinational corporations.

International cooperation. Will the changes make it easier for countries to agree on the international division of income? When writing tax rules, the United States must consider the responses of other countries. If the United States sets up rules for itself unilaterally and ignores the possible responses of other countries, unintended results may occur. For example, an increased burden on the competent authority process and/or double taxation may result if the United States adopts pricing methods that differ from methods used by other countries. Furthermore, if other countries believe that the U.S. rules disadvantage their companies, they may retaliate with rules intended to disadvantage U.S. companies.

Competitiveness. Another criterion often suggested in analyzing transfer pricing alternatives is the impact of transfer pricing rules on competitiveness. If the FCC can reduce its tax burden by using transfer prices to shift income to lower tax jurisdictions, it may have a competitive advantage over its U.S. competitors. However, as explained below, this criterion is difficult to apply for many reasons.

The worldwide tax rate of an FCC's parent is needed to determine if the FCC has a tax advantage over its competitors. If the tax that is not paid in the United States is paid elsewhere, it may confer no price or cost advantage on the FCC. Determining the effective tax rate in the home country of its parent corporation may not be possible because not all countries publish sufficient data on their multinational corporations. A comparison of nominal tax rates may be insufficient to determine an advantage because corporations can shift income into tax haven countries. Effective tax rates by country are difficult to compare because of the potential for income

shifting to tax havens and because determining the rates requires a detailed examination of each country's tax law.

The existence of an FCC tax advantage also depends on the transfer pricing practices of U.S. multinational corporations. An FCC abusing transfer pricing may have no tax advantage if a U.S. multinational competing in the same markets is equally abusive. Our 1981 report and IRS examination and appeals findings provide evidence of transfer pricing abuse by U.S. multinationals. Data are not available to assess whether foreign affiliates of U.S. corporations are paying taxes in host countries at the same rate as firms from those countries. U.S. trading partners, however, report concerns about transfer pricing practices of affiliates of U.S. and other foreign parents.

Problems in measuring the effects of a tax advantage on competitiveness are caused by difficulties in determining who really pays the corporate income tax and how the tax affects prices and rates of return. If a corporation's taxes are reduced through transfer pricing manipulation, the savings may be passed forward to consumers as price decreases to gain market share, passed back to shareholders as a higher rate of return on investment, or passed on to both consumers and shareholders.

We do not use competitiveness as a criterion for evaluating the alternatives because of these problems of determining the worldwide tax rate, determining how it differs from the tax rate on U.S. competitors, and determining its effect on prices and earnings.

Alternative 1: Formulary Apportionment

The 45 states with a corporate income tax all use formulary apportionment to allocate a particular corporation's income among themselves. The apportionment is done through a formula containing objective factors, such as the proportion of the corporation's total property, payroll, and sales in each jurisdiction. The intent is to attribute income on the basis of the share of business activity in each jurisdiction.

The formulary approach can be applied to a single corporation or to members of a group of corporations. In the latter case, the formula is applied to the income of affiliated corporations in a corporate group that is determined to be unitary. This determination is based on the degree to which the activities of the affiliated firms are interdependent.

The revenue effect of changing to the formulary approach on a worldwide basis is not clear. The income to be considered in determining U.S. income would be changed from domestic income as determined by arm's length prices to the worldwide income of the corporate group. Furthermore, the share of this worldwide income attributable to the United States would be determined by the domestic share of factors like worldwide property, payroll, and sales.

The revenue gains or losses inherent in moving from the arm's length approach to the formulary method depend on several factors. For example, if property and payroll cost less abroad than at home and if management systematically requires higher profit from offshore operations to compensate for risk, the shift from the arm's length method to the formulary approach is likely to apportion taxable income to the home country. On the other hand, if costs in foreign countries are higher, a greater share of income is likely to be apportioned abroad.

Studies of the effect of a change to the formulary method on the income of U.S. multinational corporations have shown an increase in total income apportioned to the United States. However, these studies show a great deal of variation in the effect on individual industries. For example, a study using 1977 Commerce Department data found that a change to formulary apportionment would increase U.S. income by 13.5 percent for all industries, but when the petroleum and coal industries were excluded from the study, the change would decrease U.S. income by 2.4 percent.[2] We are aware of no studies like those done for U.S. multinationals that attempt to measure the effect on income of a change to the formulary approach for FCCS operating in the United States.

Administrability. The formulary method's chief administrative advantage is that it simplifies income allocation among tax jurisdictions. The search for comparables is avoided by attributing income on the basis of a simple formula, such as the property-payroll-sales formula used by many states. The formulary approach also provides greater certainty for taxpayers by resulting in a division of income rather than a search for comparable arm's length prices that can be challenged by IRS.

Tax experts disagree about the formulary method's information requirements. Critics assert that the requirements are more burdensome than for the arm's length approach because data must be collected on

[2]Robert Tannenwald, "The Pros and Cons of Worldwide Unitary Taxation," New England Economic Review, (July/August 1984), pp. 17-28.

corporations' worldwide activities rather than only on actual transactions between local and foreign firms. Furthermore, record-keeping by subsidiaries outside the United States whose income forms a part of the worldwide income of the multinational corporation will not be uniform and, in general, will not conform to U.S. accounting conventions, reflecting local practice instead.

Supporters of the formulary method counter that the required information is more accessible than that needed under the arm's length method and is already required of U.S. multinationals because the United States taxes their income on a worldwide basis. The additional information requirements of the formulary method would be primarily attributable to foreign-based multinationals.

A major disadvantage of the formulary approach is the need to define a unitary business. This requirement is a continuing source of controversy in the states. The difficulty lies in determining what degree of common ownership or shared executive and staff functions identifies a unitary business. Complicated rules would have to be written to determine which companies qualify as members of a unitary group.

Economic efficiency. Corporations could affect the workings of apportionment formulas and reduce their taxes by shifting formula factors, such as property or employees, across borders. However, other influences on location decisions such as relative labor costs may be more important than tax differentials. Studies of the effect of state tax differentials on location decisions have produced inconclusive results.[3] Recent analysis has shown taxes to be a factor in some relocations within metropolitan areas, but the results for interstate analyses have been mixed. The effect of taxes on location remains an open rather than a settled question. However, some analysts argue that, because state tax differentials are small compared to international differentials, the effect of the formulary method on location decisions among the states will not be useful for predicting its effect across countries. We conclude that the empirical evidence is insufficient to determine whether the formulary approach would distort international business location decisions.

If an apportionment formula were to include intangible assets, rules for valuing these assets and determining their location would have to be written. Currently, the states do not include intangible assets in their

[3]These studies are summarized in Robert J. Newman, and Dennis H. Sullivan, "Econometric Analysis of Business Tax Impacts on Industrial Location: What Do We Know and How Do We Know It?", Journal Of Urban Economics, vol. 23, (1988), pp. 215-234.

apportionment formulas. Including intangibles in formulas would make it easier for corporations to shift these readily transportable assets to reduce tax.

If intangibles were excluded from formulas, the corporate owner of the intangibles would be apportioned less income than otherwise. Supporters of the formulary method argue that the benefit of an intangible is typically attributable to the corporation as a whole, not to the affiliate that "owns" the asset, and, therefore, intangibles are properly excluded from apportionment formulas. Critics argue that the arbitrariness of formulas would be increased by ignoring an important source of income for many corporations.

Income measurement. The formulary approach measures income in the subsidiary as the apportioned share of a multinational corporation's worldwide income. The approach's rationale is the view that the multinational corporation is an integrated economic enterprise. The subsidiary's income depends on the subsidiary's membership in the multinational's corporate group. The formula allocates income according to the subsidiary's share of the multinational's total business activity. The share is based on the contribution to actual multinational income as determined by the formula; it is not based on the arm's length standard, or what the subsidiary would have earned as an unrelated corporation.

Supporters of the formulary approach concede that because the multinational corporation is an integrated corporate enterprise, the separate contributions of each member of the corporate group cannot be precisely determined. The formula, therefore, approximates the subsidiary's income. Nevertheless, the supporters claim that it better measures each subsidiary's contribution to total multinational corporate income than an arm's length measure that requires transactions between related corporations to be priced as if the transactions were between unrelated corporations.

Critics of the formulary approach contend that it produces an arbitrary income allocation, i.e., one unrelated to what actually happens in particular countries. Formulas do not take into account such factors as different levels of political risk (such as expropriation) or different regulatory environments among countries. These differences, critics argue, invalidate the underlying assumption of formulary apportionment that in the long run a given amount of wages, property, or sales earns approximately the same amount of income everywhere in the world.

International cooperation. If formulas differed among countries, double taxation could occur, altering effective tax rates and affecting economic decisionmaking. Countries might have incentives to adjust formulas to reflect local conditions. International differences in the cost of labor and capital might be reflected in different weights on the factors in apportionment formulas. Uniformity of formulas might be more difficult to achieve internationally than among the states.

To avoid double taxation, a change to the formulary approach would require international agreement on the formula to be used. It would require changing the tax treaties between the United States and all its major trading partners; this would be very difficult to achieve. Because the arm's length standard is perceived to be the international standard, some countries are strongly opposed to the formulary method, and the possibility of achieving consensus might be remote and the time required substantial. If the United States proceeded on its own and adopted formulary apportionment or any other alternative not compatible with the arm's length standard, the number of double taxation cases submitted to competent authority might increase. In such cases, the United States competent authority would be at a disadvantage in negotiations with foreign competent authorities because IRS examiners would not have thoroughly developed the cases using the arm's length standard. This disadvantage could lead to greater revenue loss and double taxation.

International coordination would also be needed for a formulary system to be implemented. Issues such as the formulas used by different countries, the definition of factors used in the formulas, and rules governing the location of the factors would have to be monitored. International agreement might be needed to limit the extent to which countries could tailor their formulas to local conditions.

The first step to achieving international coordination might be a study group to write a model law. The law would need to specify such things as a uniform definition of net income, a common concept of the unitary business, a family of formulas for specific businesses, standards for the exercise of tax jurisdiction, and acceptable approaches to currency translation.

Alternative 2: Minimum Tax on Assets

Another way to overcome problems in allocating income and deductions is to have all corporations, or at least corporations that are parts of multinational groups, pay at least a minimum tax on assets. Mexico already has a minimum tax on assets. This is an idea advanced by James

Wheeler of the University of Michigan and Richard Weber of Michigan State.

Tax features. Wheeler's and Weber's minimum tax would be calculated by first imputing income to corporations. The imputed income would be a specified percentage of the adjusted book value of the corporation's assets, and applying the regular corporate tax rate to it would produce the minimum tax. The corporation would pay either the minimum tax or the corporate income tax computed the usual way, whichever is greater, and, thus, could not benefit as much as it could today from using transfer pricing to artificially reduce its income.

The purpose of the minimum tax would be to ensure that all profitable corporations doing business in the United States pay some U.S. tax. In order not to impose the tax on corporations that really have little or no income, the minimum tax would include a financial statement exception. Imputed income used for the minimum tax computation could be no greater than pretax income reported on financial statements prepared under generally accepted accounting principles, which can differ from the taxable income amount on a corporation's tax return.

To illustrate the revenue potential of the tax, Wheeler and Weber estimated the 1987 minimum tax FCCs would have paid. To do this, they multiplied what they considered a conservative 8-percent pretax imputed income rate by the $959.4 billion in total FCC assets reported by SOI. This gave them an imputed income of $76.8 billion. If this imputed income were taxed at the current 34-percent corporate tax rate, the minimum tax payment would be $26.1 billion.

This amount would be reduced by the $6.7 billion in taxes profitable FCCs would have paid using a 34-percent rate on their reported 1987 profit of $19.8 billion. Thus, Treasury would gain a net amount of $19.4 billion ($26.1 billion less $6.7 billion) in additional revenue from the minimum tax. This amount would be further reduced by corporations meeting the financial statement exception. Although Wheeler and Weber did not provide an estimate of this reduction in the tax, we believe it could be substantial, given the high percentage of corporations reporting losses for tax purposes.

Wheeler and Weber provided no estimate of potential revenue from applying the tax to all U.S. corporations, nor did they estimate the net revenue impact of replacing the current alternative minimum tax with the

minimum tax on assets. Rather, they suggested that Treasury could provide estimates of the revenue effects of such a substitution.

Administrability. A major advantage of the minimum tax for IRS is that it would simplify tax administration by replacing extensive auditing of transfer prices with a simple tax calculation. If the minimum tax described here were to replace the current alternative minimum tax, simpler tax administration would be extended to the taxpayer as well. If the new tax could not be credited against future regular taxes and if no foreign tax credit could be offset against it—both positions advocated by Wheeler and Weber—simplicity would be served.

The cost of administering the new tax has not been estimated. However, these costs might be somewhat offset if the new tax replaces the current alternative minimum tax.

New rules would be needed for the new tax. For example, rules would have to be written and administered on computing adjusted book value and on attributing financial statement income to subsidiaries. The financial statement income of each subsidiary would be an allocated share of total multinational corporate income where the share would be based on each subsidiary's proportion of the corporation's total assets. This allocation would be required to prevent the multinational corporation from using transfer pricing or other means to shift financial income between members of the corporate group to avoid the tax. In effect, the minimum tax would rely on a formula using a single factor (assets) to allocate income rather than the three-factor formula used by many states.

If FCCs were required to prepare financial statements according to U.S. standards, they might face an increased administrative burden. Wheeler and Weber argued that this burden is not excessive because requiring FCCs to prepare such statements would merely equate their treatment with that of competing U.S. corporations. Also, other countries such as Japan and the United Kingdom require U.S. subsidiaries to prepare financial statements using local accounting rules.

Economic efficiency. Like other formulary approaches to income allocation, the minimum tax might induce corporations to shift readily transportable assets, such as cash, securities, and intangibles, among jurisdictions. It might be difficult to write enforceable rules that prevent such shifting. Also, as noted by critics of formulary apportionment, different accounting rules in different countries can make it difficult to

determine the value of assets in different locations. Valuations of intangibles could be used by companies to affect the size of their asset base and consequently the minimum tax that they pay. The location of intangibles could also be manipulated to evade the tax. Corporations could shift intangibles such as patents to low tax jurisdictions in order to reduce their tax payments. Thus, in addition to the problem of valuing intangible asset transfers that IRS faces under current law, it would also have the problem of determining whether the asset is located in a subsidiary for legitimate business reasons or to avoid the tax.

Wheeler and Weber argued that the minimum tax would not risk double taxation because it would apply only to income attributed to assets in the United States; it would not tax income attributed to foreign assets. However, double taxation could result because a part of the income imputed in and taxed by the United States could also be considered as arm's length income by the home country and taxed there. The minimum tax would not produce double taxation if all other countries adopted the minimum tax, agreed to the same definition of the asset base, and used the same implied tax rate.

The minimum tax, however, would be arbitrary. A single rate of return on assets would be used to impute income to corporations that may differ in size, industry, and age. These corporations may not really earn the same rate of return. This problem would be mitigated by the financial statement exception, but IRS would have to examine financial statements as well as tax returns and might be required to set financial accounting standards in order to prevent abuse of the financial statement exception.

Income measurement. The minimum tax would impute income to a corporation based on a required rate of return on assets. It would not be an attempt to better measure income; rather, its purpose would be to ensure that all profitable corporations paid some tax. It would increase the income, and thus the tax, of those corporations reporting a rate of return below the required rate. If there is widespread transfer pricing abuse, the increased income in the aggregate might better reflect actual income. However, because the minimum tax imputes income to all corporations as a given return on assets, there might still be undertaxation of highly profitable corporations. Also, some corporations with legitimate losses might be overtaxed, though the potential for this would be limited by the financial statement exception.

International cooperation. Foreign treaty partners might perceive the tax as arbitrary and retaliate against U.S. companies operating within their boundaries by imposing a minimum tax of their own. Because the tax is not based on the arm's length standard, it would conflict with bilateral tax treaties. If the tax were applied to FCCs alone, it might also violate the nondiscrimination articles of the tax treaties. The tax would not be discriminatory if it were applied to all U.S.- and foreign-controlled corporations but it would be a fundamental change in the corporate income tax and would have to be evaluated on bases other than the effect on transfer pricing alone.

Alternative 3: Business Transfer Tax

Replacing the U.S. corporate income tax with a business transfer tax (BTT) has been proposed as another solution to the problem of allocating income and deductions among related parties.

Features of the tax. The BTT is a type of value-added tax. Firms buy goods and services from suppliers and produce other goods and services by processing or otherwise adding value to the purchases. Corporations compute this added value by subtracting all their purchases from all their sales. They multiply the difference by the appropriate tax rate to get the amount of tax they owe.[4] In addition, they pay tax at this same rate on the value of their imports.

Proponents of the BTT argue that because it is a destination principle value-added tax on goods and services rather than income, it could eliminate transfer pricing abuse on inbound transfers. The destination principle implies that a country taxes only domestically consumed goods and services whether produced at home or abroad. Imports, because they are consumed domestically, would be subject to the tax on entering the country. Goods and services transferred from a foreign parent to a U.S. subsidiary would be taxed when they come into the country and the value added by the U.S. subsidiary would be taxed when the goods and services are sold.

The BTT would eliminate the incentive to manipulate transfer prices on inbound transfers. For example, if a foreign parent lowered transfer prices to reduce an FCC's tax on items coming into the United States, the

[4]This approach is called the subtraction method of computing the value-added tax. An alternative way of calculating the tax—the tax-credit method—could also be used. Under this method, the tax is calculated on the basis of individual transactions, i.e., on each purchase and sale. The individual calculations are then aggregated into the total tax a firm collects on all its sales and the total tax it pays on all its purchases. The difference is the tax liability of the firm.

reduction would be offset by an increase in the tax paid on the higher value added when the item is sold; if the parent raised transfer prices to reduce the tax at the time of the sale by the FCC, the reduction would be offset by the increase in the tax when the item entered the country. However, critics of the BTT contend that a credit method value-added tax would better ensure the accurate valuation of imports. The subtraction method BTT does not provide an audit trail of tax invoices and may therefore be more susceptible to evasion.

Prices on outbound transfers might still be manipulated to reduce tax. Under the BTT, exports would be free of tax. Thus, corporations would have an incentive to allocate the largest portion of gross receipts to exports. A method for doing this would be to raise the transfer prices of goods shipped to foreign parents or subsidiaries. Such methods are less likely to succeed under a credit method value-added tax than under the subtraction method BTT.

Evaluating all the ramifications of replacing the corporate income tax with the BTT is the subject of an ongoing GAO study and is beyond the scope of this report. Such a major change in the tax system must be evaluated for effects far beyond its impact on transfer pricing abuse. We have, however, issued several reports on the value-added tax that addressed revenue, administrative, and economic considerations.[5]

The value-added tax is believed to have tremendous revenue potential because its base can be as large as all consumption in the United States. The broad base of the tax allows large revenue gains from small increases in tax rates. However, if the BTT were to replace the corporate income tax, the rate could be adjusted, at least initially, to produce a revenue-neutral result. From a transfer pricing standpoint, because the BTT would remove any advantage from transfer pricing manipulation on inbound transfers, the amount that the border tax would add to revenue by eliminating transfer pricing abuse would depend on how much abuse is occurring.

Administrability. There are no reliable estimates of administrative costs. The costs would depend on features of the tax, such as whether the subtraction or tax-credit method for computing the tax is used, whether exemptions and multiple rates are permitted, and the extent to which small businesses are covered. If the BTT were to replace the corporate

[5]Tax Policy: Choosing Among Consumption Taxes (GAO/GGD-86-91, Aug. 1986); Tax Policy: Tax-Credit and Subtraction Methods of Calculating a Value-Added Tax (GAO/GGD-89-87, June 20, 1989); and Tax Policy: Value-Added Tax Issues for U.S. Policymakers (GAO/GGD-89-125BR, Sept. 15, 1989).

income tax, the administrative costs of the BTT would have to be compared with the current cost of administering the corporate income tax. Because the BTT would be a new tax, estimates would be required of the time and costs involved in setting up new systems, regulations, instructions, etc.

Economic efficiency. A value-added tax with a single rate and a comprehensive base would not affect decisions concerning what goods to consume or what production techniques to use in producing those goods. The decisions would be made on the basis of market prices, not taxes. However, the value-added tax could affect choices between earning more income to buy higher priced goods and forgoing work and enjoying leisure. This is because the value-added tax taxes consumption but not the benefits of leisure. The value-added tax could also distort choices among consumer goods if multiple rates and exemptions were introduced to offset its perceived regressivity. Higher rates could be imposed on "luxury goods" and lower taxes on necessities. These multiple rates and exemptions would reduce the economic neutrality of the tax.

Income measurement. The BTT is a value-added tax on goods and services. Because the tax is not based on income, the issue of income measurement does not arise.

International cooperation. Because most industrialized countries use the destination principle value-added tax, the United States would be conforming to common international practice by adopting such a tax. However, no country within the Organization for Economic Cooperation and Development except Japan uses the subtraction method value-added tax on goods and services. Critics of the BTT contend that because imports and exports are likely to be valued less accurately under the BTT, these valuations may invite objections from U.S. trading partners.

Alternative 4: Expanding Safe Harbors

A common suggestion for handling section 482 matters is to expand the use of simple tests called safe harbors or safe havens. A safe harbor is a provision in the Internal Revenue Code or regulations that has the effect of ensuring a particular tax result if objective conditions are met.

For example, Treasury regulations provide a safe harbor range between a maximum and minimum interest rate for intercompany loans, and IRS does not challenge intercompany interest rates within this range that companies report. If the company does not charge interest, or if it charges a rate outside the safe harbor range, IRS may adjust the rate to either the

maximum or minimum rate unless the taxpayer can establish a more appropriate rate under the arm's length standard. This adjustment would affect the interest deemed to have been paid and consequently the income on which taxes are to be computed.

Possible expansions of the safe harbor concept would have other goods and services also priced within ranges worked out on an industry or product line basis. The safe harbor could be a specified range of prices for products, a formula for computing the prices, or a formula for dividing the income associated with a particular transaction. Formulas for dividing income could be similar to the three-factor formulas used by the states or could be based on a profit split according to some percentage specified in regulations.

Safe harbors could be designed to include either rebuttable or conclusive presumptions. When a rebuttable presumption is used, safe harbor levels apply to a taxpayer unless the taxpayer can argue, using arm's length prices or some other basis, that the safe harbor does not apply. In this case, the safe harbor could be a fourth method that is presumed to apply unless the taxpayer can demonstrate that the income allocation is based on arm's length prices derived using the methods now specified in the regulations. The conclusive presumption makes the safe harbor mandatory: the taxpayer must use the safe harbor and cannot appeal an IRS adjustment if it does not use the safe harbor.

A major fear expressed about the increased use of rebuttable safe harbors for goods and services is that the government would lose money. Taxpayers would only choose to use safe harbors instead of the usual arm's length approach if they would end up paying less in taxes. In other words, the safe harbor would provide a ceiling for taxes paid.

Corporations that could lower their taxable income by using prices within the safe harbor range would use the safe harbor; corporations whose taxable income would be increased by prices within the safe harbor range would be inclined to argue that their income allocation is based on arm's length prices and should not be subject to the safe harbor. The corporations would then pay no more tax than the safe harbor would allow and could pay less. The White Paper concluded that no safe harbors had been proposed that did not have the potential for abuse.

Under the conclusive presumption, a corporation could no longer pay less tax than the safe harbor allows by arguing that the income allocation is

based on arm's length prices. Tax revenue from these corporations is likely to be higher than under the rebuttable safe harbor or the current arm's length approach. Corporations whose taxable income would be lowered by the safe harbor are likely to pay less tax. The amount of revenue lost from these taxpayers would depend on how the safe harbor was determined.

Proponents of rebuttable safe harbors argue that by adding certainty to corporations' tax calculations and eliminating the risk of IRS adjustment and its attendant costs, safe harbors would be used by some corporations even when their income subject to tax would increase. The higher tax they would pay would reduce the revenue loss to the Treasury that safe harbors would otherwise bring. A full evaluation of the revenue effects of safe harbors would entail further study of this revenue loss and an estimate of savings in administrative costs.

One of IRS' hopes is that its use of advance pricing agreements will provide industry information that might be useful in constructing safe harbors, possibly in the form of profit splits. In a profit split, the total income allocable to a transaction is divided between related parties according to percentages specified by IRS. The Internal Revenue Code currently provides a safe harbor profit split for U.S. parents and their foreign sales corporation subsidiaries. Experimenting with other safe harbors in different industries over a period of time could provide estimates of revenue loss and administrative cost savings.

Administrability. Under safe harbors, administrative costs should be reduced for both taxpayers and IRS. Relatively simple safe harbor rules would replace complex pricing regulations. As mentioned earlier, safe harbors would provide increased certainty for the taxpayer, and, it is claimed, the taxpayer would not be subject to adjustments IRS determines through hindsight. Safe harbors would also ease enforcement problems for IRS since intercompany prices falling within safe harbor ranges would not have to be scrutinized.

However, safe harbors may be difficult to construct and administer for the types of intangible properties that have given rise to transfer pricing problems in the past. Because such properties typically lack comparable prices, IRS may have trouble constructing safe harbors that do not provide a windfall for taxpayers. The safe harbors could create disputes between IRS and taxpayers about what properties qualify for safe harbor treatment. IRS and the taxpayer may also disagree about what tangible properties or

products qualify for safe harbor treatment. Furthermore, the lack of data about comparable prices may make it difficult for IRS to adjust the safe harbors to reflect changing economic conditions. Finally, if the safe harbors are not accepted internationally and double taxation results, the number of cases in the competent authority process may increase with the attendant problems described earlier regarding formulary apportionment.

Economic efficiency. Economic distortions would depend on the types of safe harbors adopted. For example, a formulary safe harbor may have the same asset shifting consequences mentioned earlier in the context of formulary apportionment.

The arbitrary nature of safe harbors might negatively affect some taxpayers. For example, a profit split that is not tied to objective factors or a rate of return that is based on industry averages over time might discourage investment by imposing excessive tax burdens on start-up companies, which typically earn lower incomes than more mature firms. The potential for unfair treatment of taxpayers would be reduced when the safe harbor is rebuttable rather than conclusive.

Income measurement. The purpose of safe harbors is not to produce a better measurement of income but to reduce uncertainty and administrative costs for the taxpayer and IRS. Both taxpayers and IRS might sacrifice some accuracy in reported income to achieve the lower costs and greater certainty. IRS might set a range of prices or rates of return as safe harbors that it expected to be accurate for most taxpayers. However, as discussed above, some taxpayers might report some income within the safe harbors to reduce uncertainty although their income fell below the safe harbor range. Other taxpayers whose actual income exceeded the safe harbor range might report income within the range to lower their tax.

International cooperation. Other countries might object to certain kinds of safe harbors. For instance, a safe harbor that gave the United States a specific percentage, say 50 percent, of the income in all transfer pricing cases would sometimes disadvantage foreign countries. The specific safe harbors chosen must be coordinated with other countries, or U.S. taxpayers would risk double taxation. Some transfer pricing analysts have recommended using safe harbors as fourth methods rebuttable with arm's length prices derived using the comparable uncontrolled price, the resale price, or the cost plus methods. According to this view, using safe harbors like this could be a way to introduce alternatives to the arm's

length standard like formulary apportionment into U.S. regulations without having to renegotiate U.S. bilateral tax treaties.

Alternative 5: Expanding Methods to Allocate Income and Deductions Among Related Parties

Another way for IRS to ease its problems of allocating income and deductions among related parties from international business transactions could be to use industry comparisons as the basis for allocation. The current regulations implementing the Treasury Secretary's authority to adjust gross income, deductions, credits, and allowances to reflect income are rules for calculating transfer prices based on arm's length pricing standards. The use of financial attributes of similar businesses to provide a standard for reflecting income could supplement this system. This would provide specific authority for some judicial decisions that have been characterized as attempting to achieve rough economic justice without an explicit rationale.[6]

Under a new regulatory system based on industry norms, a tax could be structured by comparing company ratios such as those between gross profit and sales or U.S. taxes paid and sales to an industry norm for the same ratio. The industry norm could be the mean value of the industry ratio, the median value, or whatever other value is deemed appropriate. A lower-than-reasonable company ratio would reflect a lower-than-reasonable income level. If the company's ratio were below a reasonable percentage of the industry norm over a period of time, the income tax would be calculated on the basis of the norm to reflect income. The new approach would increase the company's ratio to the acceptable percentage of the industry norm.

Such a regulatory approach could be imposed in a different way in each of three periods of the life of a company. A company just starting out could be given a grace period before it would be subject to the industry norm to allow for differences between start-up companies and established firms. After the grace period, the company could rebut the imposition of the tax under the industry norm approach. In the third and final period, if a company's ratios in most years were still below the acceptable percentage of the industry norm, the adjustment to the tax would be mandatory and not rebuttable.

The regulatory approach described here would presume that companies existing for a sufficiently long period of time and still falling below the

[6]D. Kevin Dolan, "Intercompany Transfer Pricing for the Layman," Tax Notes (Oct. 8, 1990), pp. 216-217 and 222.

maximum or minimum rate unless the taxpayer can establish a more appropriate rate under the arm's length standard. This adjustment would affect the interest deemed to have been paid and consequently the income on which taxes are to be computed.

Possible expansions of the safe harbor concept would have other goods and services also priced within ranges worked out on an industry or product line basis. The safe harbor could be a specified range of prices for products, a formula for computing the prices, or a formula for dividing the income associated with a particular transaction. Formulas for dividing income could be similar to the three-factor formulas used by the states or could be based on a profit split according to some percentage specified in regulations.

Safe harbors could be designed to include either rebuttable or conclusive presumptions. When a rebuttable presumption is used, safe harbor levels apply to a taxpayer unless the taxpayer can argue, using arm's length prices or some other basis, that the safe harbor does not apply. In this case, the safe harbor could be a fourth method that is presumed to apply unless the taxpayer can demonstrate that the income allocation is based on arm's length prices derived using the methods now specified in the regulations. The conclusive presumption makes the safe harbor mandatory: the taxpayer must use the safe harbor and cannot appeal an IRS adjustment if it does not use the safe harbor.

A major fear expressed about the increased use of rebuttable safe harbors for goods and services is that the government would lose money. Taxpayers would only choose to use safe harbors instead of the usual arm's length approach if they would end up paying less in taxes. In other words, the safe harbor would provide a ceiling for taxes paid.

Corporations that could lower their taxable income by using prices within the safe harbor range would use the safe harbor; corporations whose taxable income would be increased by prices within the safe harbor range would be inclined to argue that their income allocation is based on arm's length prices and should not be subject to the safe harbor. The corporations would then pay no more tax than the safe harbor would allow and could pay less. The White Paper concluded that no safe harbors had been proposed that did not have the potential for abuse.

Under the conclusive presumption, a corporation could no longer pay less tax than the safe harbor allows by arguing that the income allocation is

based on arm's length prices. Tax revenue from these corporations is likely to be higher than under the rebuttable safe harbor or the current arm's length approach. Corporations whose taxable income would be lowered by the safe harbor are likely to pay less tax. The amount of revenue lost from these taxpayers would depend on how the safe harbor was determined.

Proponents of rebuttable safe harbors argue that by adding certainty to corporations' tax calculations and eliminating the risk of IRS adjustment and its attendant costs, safe harbors would be used by some corporations even when their income subject to tax would increase. The higher tax they would pay would reduce the revenue loss to the Treasury that safe harbors would otherwise bring. A full evaluation of the revenue effects of safe harbors would entail further study of this revenue loss and an estimate of savings in administrative costs.

One of IRS' hopes is that its use of advance pricing agreements will provide industry information that might be useful in constructing safe harbors, possibly in the form of profit splits. In a profit split, the total income allocable to a transaction is divided between related parties according to percentages specified by IRS. The Internal Revenue Code currently provides a safe harbor profit split for U.S. parents and their foreign sales corporation subsidiaries. Experimenting with other safe harbors in different industries over a period of time could provide estimates of revenue loss and administrative cost savings.

Administrability. Under safe harbors, administrative costs should be reduced for both taxpayers and IRS. Relatively simple safe harbor rules would replace complex pricing regulations. As mentioned earlier, safe harbors would provide increased certainty for the taxpayer, and, it is claimed, the taxpayer would not be subject to adjustments IRS determines through hindsight. Safe harbors would also ease enforcement problems for IRS since intercompany prices falling within safe harbor ranges would not have to be scrutinized.

However, safe harbors may be difficult to construct and administer for the types of intangible properties that have given rise to transfer pricing problems in the past. Because such properties typically lack comparable prices, IRS may have trouble constructing safe harbors that do not provide a windfall for taxpayers. The safe harbors could create disputes between IRS and taxpayers about what properties qualify for safe harbor treatment. IRS and the taxpayer may also disagree about what tangible properties or

acceptable percentage of the industry norm were not accurately allocating income to their U.S. operations with intercompany pricing calculations. The underlying presumption for either a rebuttable or a nonrebuttable income allocation would be that parties unrelated to each other would not continue to enter into agreements that resulted in sustained losses or minimal profits for that length of time. The arm's length standard would be viewed in a broad sense of reflecting business done on an arm's length basis rather than a narrower sense of relating to arm's length prices.

This regulatory scheme appears to be consistent with at least one foreign court case. In a 1988 case, a German court ruled that a particular company continually losing money should have paid its related parent lower prices for intercompany purchases or should have liquidated.[7] The court concluded that it was not plausible for an affiliate operating as an independent entity to continually fail to make profit and continue in the same relationship with its parents or other related business entities. Strangers would have changed their relationship. The court concluded that an implied dividend was being paid to the parent, and income was allocated to the affiliate.

Under the allowable methods of allocating income among related parties in current regulations, some U.S. courts have rejected the use of industry statistics[8] because they found that the statistics used were not based on comparable transactions or on ratios calculated from companies with sufficient degrees of comparability as required in the current regulatory scheme. The industry norm method of calculating the income tax seems consistent with the very broad language of section 482. According to the statute, the Secretary of the Treasury is authorized to distribute, apportion, or allocate income, deductions, credits, or allowances in any case of two or more organizations, trades, or businesses that are owned or controlled by the same interests to reflect income or prevent evasion of taxation. If incorporated into new regulations, the industry norm method might result in more certainty for taxpayers, courts, and IRS.

Because FCC ratios of gross profits and taxes paid to sales have often been lower than domestic ratios, many FCCs would face higher taxes if their ratios were adjusted to meet industry norms calculated using data that included domestic firms. To the extent that an additional tax based on the use of norms would be paid by companies that previously made low tax payments, more revenue would be collected from these firms.

[7] Hesse Fiscal Court judgment of October 17, 1988, IV 298/82, RIW 89, 408.

[8] An example is E. I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979).

Because the tax would be based on industry norms, it would be affected by the past compliance with the tax laws of the firms in the industry. An industry with a large proportion of companies that had abused transfer prices (or otherwise evaded taxes) may have had a lower average gross profit or tax rate than an industry where most companies were in compliance. Alternatively, the greatest proportion of abusers might be in industries where the industry as a whole had a higher gross profit ratio or paid a higher rate of tax than industries with fewer abusers. As a result, the companies in the first industry should be subject to an even higher percentage of the industry norm than the second industry. Thus, besides reflecting economic differences among industries, the acceptable percentage of the industry norm might have to be further adjusted to reflect different levels of abuse in different industries. Even with these adjustments, the calculation is intended to limit the extent of underpayment by acting as a backstop that ensures that all FCCs pay some acceptable level of tax.

Administrability. Applying ratios might narrow the controversies and amounts in dispute between IRS and taxpayers. It could also be simpler than using the current case-by-case approach to transfer pricing cases. The use of this type of standard could limit the extent of controversies by either requiring a specific level of proof on the part of the taxpayer or by requiring that a certain amount of tax be paid. This could limit the magnitude of controversies during an audit and lessen the need for actual audits compared to the rules that have been in effect. However, if the allocation methods were not accepted internationally, unilateral adoption of the methods by the United States could lead to double taxation and increased pressure on the competent authority process.

If a method like the one described above were to be imposed, IRS would have to provide tables of industry ratios for taxpayers to use. The "lower-than-reasonable" percentage of the industry norm might be difficult to determine for some industries. Rules would be needed to determine the age of a corporation. Rules would also be needed to guard against companies inappropriately assigning themselves to specific industries to take advantage of favorable average tax rates.

The calculation of the ratios would require that industry data be as up to date as possible. In the 1991 tax year, the most recent available SOI data was from 1988. The implementation of the tax would possibly require that IRS compile at least some industry statistics on a more timely basis. However, there will always be some lag between the year in which taxes

are paid and the availability of industry statistics. Thus, the tax would be based on performance in prior years and not on current industry averages. This might cause the tax to be excessively high in some years in industries with large year-to-year fluctuations in taxes paid if adjustments are not made. Using average periods of sufficient duration would be needed to minimize distortions.

The broad industry classifications now used by IRS might have to be refined or the norms might have to be based on product lines rather than industries. As pointed out in chapter 2, the current classifications are so broad that they include many kinds of companies with varying degrees of profitability. A norm calculated for the industry as a whole might not be appropriate for each company in the industry.

Economic efficiency. The use of industry norms to determine tax liability could interfere with business decisions. The tax treatment of companies that fall below an acceptable percentage of the industry norm would vary across industries because both the norms and the acceptable percentages would vary. Because industries with higher norms and acceptable percentages might be viewed by investors as more heavily taxed, investment could be discouraged in those industries. Thus, the tax could affect investment decisions by distorting the investors' views of relative after-tax returns on investment.

The approach described here, however, would be designed to limit any distortionary impact. The tax based on industry norms would apply only when companies' ratios fall below an acceptable percentage of the industry norm. The acceptable percentage would be set so that only companies showing unreasonably low ratios fall below it. The number of companies subject to the tax would be limited, and other companies in the industry would be unaffected. Furthermore, the approach would permit a grace period for start-up companies to minimize any impact of the tax on investment in the new companies in an industry.

Income measurement. For companies subject to the tax, a tax based on an acceptable percentage of the industry norm might better reflect their true income than a tax on the income that results from their intercompany pricing calculations. Under the presumption of the new regulatory approach described here, companies subject to the tax would have been existing too long to earn zero or minimal profits or to pay no tax or a very small percentage of the industry norm. These companies would be presumed to be undertaxed, and the adjustment of their ratios to the

acceptable percentage would raise their tax to a level that better reflected their true income.

However, a tax based on industry norms might overtax some established companies with weak earnings. A company making a very large, bad investment and taking years to emerge from its effects might be required to pay much higher taxes than warranted by its earnings. The potential for overtaxation could be reduced, for example, if the average of a company's past profits or tax payments was used to determine whether the company met the acceptable percentage of the industry norm. A record of tax compliance by the company making the bad investment might enable it to meet the minimum percentage during the years when its earnings are low. A record of underpayment of taxes, by lowering the average of past tax payments, would not help the company meet the minimum acceptable percentage.

International cooperation. Foreign trading partners might question the use of industry norms in place of case-by-case transfer pricing determinations. If they perceived the tax as a departure from, rather than a different form of, the arm's length standard leading to the double taxation of their own multinational corporations, they might insist on renegotiation of tax treaties or retaliate against U.S. companies operating within their borders. However, as discussed earlier, there is evidence of another country using the absence of income in an affiliate over a sufficient length of time as evidence of non-arm's length pricing.

If the approach discussed here were applied only to FCCs, it might be viewed as discriminatory. The United States is committed in its tax treaties not to discriminate.

However, it might be possible to argue that, according to the rationale of the approach, affiliates that did not meet the minimum percentage of the industry norm were not pricing at arm's length and the tax was therefore an enforcement tool permitted under the treaties. U.S. tax laws distinguish between the information made available to IRS from controlled foreign subsidiaries of U.S. corporations and from foreign affiliates operating in the United States. Foreign-controlled affiliates operating in the United States need only provide information relevant to U.S. operations. U.S. foreign operations, on the other hand, must more fully report all their activity because of the U.S. taxation of worldwide income. The difference allows deferrals under worldwide taxation of U.S. corporations to be calculated in a manner that is simply not done for foreign corporations.

This additional information and the application of worldwide tax principles to U.S. companies could be the basis for applying different rules for calculating income taxes.

If, however, discrimination were still considered a problem, it could be avoided by imposing the same type of tax calculation on all U.S. taxpayers with foreign operations as well as on FCCs with intercompany transfers. It might also be sound tax policy without regard to discrimination considerations because of transfer pricing problems of U.S. corporations.

Expanded Allocation Methods' Relationship to Proposed Transfer Pricing Regulations

On January 24, 1992, IRS issued proposed regulations for intercompany transfer pricing. While these proposed regulations differ substantially from any of the options discussed in this chapter, they seem to have the most in common with the option we are calling "expanded allocation methods." Some of the same factors that we discussed in connection with this option need to be considered as Treasury weighs the comments it receives on the proposed regulations.

The proposed regulations change the way that transfer prices are determined for both tangible and intangible goods. They provide that when comparable transactions of unrelated companies cannot be found, arm's length prices must be based on the profitability of unrelated companies engaged in similar activities. This profitability may be based on product lines, the different functions of the companies, or the operation of the companies as a whole.

The regulations introduce three new methods for determining arm's length prices for intangibles. The first two methods—the matching transactions and the comparable adjustable transactions methods—are based primarily on the prices charged in comparable transactions of unrelated parties. The third method is based on the profitability of similar companies.

The third method applies when neither matching transactions nor comparable adjustable transactions can be found. This comparable profit method compares the income of related parties to the income of unrelated parties performing similar functions or dealing with similar products. The comparison is based on measures of profitability such as the income-to-asset or income-to-sales ratios of the similar companies. An interval is constructed from the income that the related party would have earned if it had the same value of the profitability measure (the same income-to-asset ratio or the same income-to-sales ratio) as the

comparable, unrelated companies. If the reported income of the related company lies outside the interval, IRS can adjust the company's income to lie within the interval. IRS can also make this adjustment if the second method results in income lying outside the interval. If the income is within the interval, ordinarily no adjustment will be made.

The profitability measures used to construct the intervals may be derived from a very few companies whose functions and products are similar to the related party or from an industrywide group of such companies. The number of comparable companies used will depend on the availability of reliable data. The profitability measures are averaged over an appropriate period which, in the absence of a showing that a different period is better, will be a 3-year period that includes the taxable year under review, the preceding year, and the following year.

The proposed regulations also modify the rules for pricing transfers of tangible goods to conform to these new methods for pricing intangibles by applying the comparable profit interval to these transfers. When the related party cannot find a comparable uncontrolled price, the income of the related party may be adjusted to fall within an interval based on the incomes of comparable companies as described above. Thus, transfer prices derived using the resale price method, the cost plus method, or any of the so-called fourth methods can be changed by IRS to produce an income for the related party that lies within the interval.

Both the expanded allocation methods we have discussed and the proposed regulations attribute income to a company based on the incomes of other companies. The allocation methods adjust income to an acceptable percentage of an industry norm, and the proposed regulations adjust income to an interval based on the profitability of comparable companies.

The allocation methods try to give taxpayers greater certainty regarding their transfer prices than they had before by requiring industry norms to be computed and made public by IRS. This public notice permits the taxpayer to know if its transfer prices result in incomes that meet the acceptable percentage of the industry norm. The regulations make no provision for prior notice to companies of the profit intervals to which they are assigned by IRS. Because these intervals are company specific, it would seem to be impractical for IRS to try to give such prior notice. The intervals will be determined by IRS during its examination of the companies after the prices have been set.

The regulations suggest that uncertainty will be reduced because taxpayers will be able to estimate the profit intervals. The estimation would require taxpayers to (1) identify companies carrying out similar functions or dealing with similar products and (2) acquire financial data about them to construct the intervals. Financial data for individual products, product lines, or the functions of different parts of companies may not be readily available. Estimation is made more difficult by basing profitability measures generally on 3-year averages that include the year after the transfer prices in question have been set. Under this scheme, taxpayers must estimate their own income and the income of comparable companies in the next tax year.

The allocation methods are intended to reduce administrative burden by replacing the case-by-case approach with the requirement that all companies pay at least a certain amount of tax based on industry norms. Similarly, when the third method of the proposed regulations applies, administrative burden may also be reduced to some extent. In this method, which is based on the income of companies engaged in similar activities, the proposed regulations depart from a transaction-by-transaction approach to transfer pricing. However, comparable companies must be selected and analyzed based on the facts and circumstances of the functions and products involved in the transactions between related parties. The effect of the regulations may be to replace current disputes about comparable prices with disputes about which companies are engaged in comparable activities.

Both the proposed regulations and the allocation methods may overtax companies with weak earnings. A company making a bad investment and taking years to recover may have its income adjusted on the basis of the profitability of companies that did not make the same strategic error.

Like the allocation methods, if the regulations are perceived by trading partners as departures from arm's length pricing, they may lead to double taxation and may increase pressure on the competent authority process or provoke retaliation. The regulations may be more likely to be perceived as consistent with arm's length pricing than the allocation methods. Under the proposed regulations, the adjustment to the profit interval occurs only when matching transactions for intangibles and comparable uncontrolled prices for tangibles cannot be found. The allocation methods, after initial periods, cannot be rebutted with arm's length prices.

Increased Use of Arbitration

An idea suggested more as a procedural change than as a revamping of the arm's length approach is to apply arbitration to the transfer pricing area. In arbitration, an objective, outside party would hear and settle, on a binding or a nonbinding basis, transfer pricing disputes among tax authorities and taxpayers.

Tax law experts have proposed using arbitration procedures at various points when a transfer pricing dispute arises—instead of litigation, within the competent authority context, and after advance pricing agreements are reached. According to its proponents, binding arbitration introduced at any of these stages in the dispute could reduce delay and uncertainty for both the taxpayer and IRS.

Examples of proposed and implemented arbitration procedures. IRS' Chief Counsel has called for greater use of arbitration as an alternative to litigation. He has urged greater openness to using Tax Court Rule 124, which covers voluntary binding arbitration. Under this rule, at any time that a factual case in controversy is at issue and before trial, the parties to the case may move that it be resolved through voluntary binding arbitration. According to IRS officials, the relatively new rule had not yet been used much in general or in section 482 cases.

Arbitration has been proposed to reduce the time and uncertainty involved in the competent authority decisionmaking process. The members of the European Community have agreed to a convention, still to be ratified by member countries, requiring arbitration if the competent authorities cannot reach agreement within a set period. The taxpayer has the right to argue its case before an arbitration commission, and the commission also has a set period to decide a case. Arbitration is binding—the taxpayer and the tax authorities are obliged to accept the commission's decisions unless the competent authorities agree on an approach different from the commission's.

The recently implemented tax treaty between the United States and the Federal Republic of Germany is the only U.S. tax treaty with a binding arbitration provision. The treaty allows the two countries' competent authorities to submit a disagreement to binding arbitration if they and the taxpayers agree to submit it. The staff of the Joint Committee on Taxation said in a report prepared for a hearing on the treaty with Germany that the international tax system might have much to gain from the arbitration experiment with Germany.

Arbitration has also been proposed to resolve disputes between taxpayers and IRS over agreed upon methodology for advance pricing agreements and over how it should be applied when economic circumstances change. Individuals within the Section of Taxation of the American Bar Association have proposed two-tier arbitration as part of advance pricing agreements. The taxpayer and IRS would agree not only to be bound by the pricing methodology but also to submit any later disputes relating to the agreement to binding arbitration. The agreement would stipulate that the arbitration be winner-take-all, i.e., the arbiter must accept the IRS or taxpayer position and could not split the difference. It would also stipulate that the losing party in the arbitration pay all costs.

Administrability: arguments for arbitration. The first proarbitration argument is that arbitration means that taxpayers could count on timely decisions and there would be fewer delays in bringing problems to the decisionmaker. IRS and taxpayers currently spend vast resources on litigation. Arbitration would permit a quicker settlement at a lower cost, although the cost could still be significant. Also, competent authority has been criticized as an extremely slow process, and arbitration would limit how long the process could continue. Finally, arbitration leading to a speedy revision of advance pricing agreements when economic circumstances change would make the agreements more attractive to the taxpayer and IRS.

Proponents argue that arbitration has other advantages that apply to all stages in a transfer pricing dispute. Using impartial experts in arbitration who are familiar with commercial and industrial environments could lessen IRS' and taxpayers' need to elaborately prepare cases. This could expedite dispute resolution and reduce costs.

Proponents also argue that arbitration decisions would be based less on rigid interpretation of pricing rules than on the arbiter's experience in a particular industry and sense of fairness. Arbiters might be more open than tax authorities to considering factors that might endanger other cases pending with the authorities.

Having arbitration procedures should encourage more informal dispute resolution without resort to arbitration, let alone litigation. One goal of the American Bar Association members' proposal is to encourage more parties to settle their disagreements informally, not to force parties to arbitrate all differences. Proposal features such as the losers bearing costs and the

winners winning everything are intended to be incentives for settlement short of arbitration.

Administrability: arguments against arbitration. In 1984, the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development argued against using arbitration with competent authority because it believed that the existing system was adequate and did not warrant new procedures. In this view, the objections that competent authority was uncertain and time-consuming were not supported by evidence. Uncertainty was inherent in the process, and speed could be enhanced by increasing competent authority resources. Overall, the argument went, competent authority was a useful tool, and acceptable compromises were nearly always reached.

Administrative issue: design of the arbitration procedure. One question that would have to be answered regarding arbitration is whether it should be final or subject to appeal. The advantage of the right to appeal is that it would protect the parties from what they may regard as arbitrary decisions. Its disadvantage is that it would reduce the speed and certainty of the arbitration process.

Another question is whether arbiters should be pragmatic and work for a simple compromise or legalistic and work for the correct solution as a court would. The pragmatic approach might be quicker and less expensive but could lead the parties to the dispute not to concede points in preliminary negotiations, hoping for a compromise between both parties' positions. Without a winner-take-all rule, arbitration might hinder the informal settlement of disputes.

Economic efficiency. The availability of arbitration procedures is not likely to affect business decisions. Employment and investment decisions are not likely to change to affect a bargaining position in a future arbitrated price dispute.

Income measurement. Arbitration is a procedure intended to resolve transfer pricing disputes on a more timely basis. Whether arbitration also produces an income allocation that better reflects the actual income of the parties to the dispute depends on factors such as how knowledgeable the arbiters are about economic and industry conditions and the relative abilities of the parties to support their positions.

International cooperation. A major problem associated with arbitration involving a large number of countries and their competent authorities is the considerable international cooperation that would be required to set up mutually acceptable arbitration procedures. Multinational agreements on arbitration instead of competent authority are made more difficult by some countries' fear that arbitration might represent a loss of sovereignty with tax decisions taken out of their hands. However, the bilateral approach embodied in the U.S.-Germany treaty is seen by commentators as a promising initiative.

Conclusions

The arm's length standard has been the U.S. way of dealing with transfer pricing for decades and is considered to be the international norm as well. Using the standard as its foundation, Treasury has been working to resolve transfer pricing issues for years, to the point where it recently proposed new transfer pricing regulations. Nevertheless, arm's length pricing has created many problems, and difficulties will continue despite all the recent initiatives in the transfer pricing area.

There are many reasons why an early end to transfer pricing problems is not ensured. The large amount of globalization of trade and the resulting transfer pricing caseload, the transfer pricing problem's continuing factual nature, the uncertainty in how the controversy over intangibles will be resolved, and the hurdles to be overcome in the advance pricing agreement program all argue for the problem not going away soon.

Although the alternatives described in this chapter vary in their approaches to overcoming problems with arm's length pricing, they do have some common elements. Each has problems of its own, but each also aims to ease the case-by-case administrative burden that has plagued transfer pricing and to add some degree of standardization to the process. All except arbitration affect economic decisionmaking, and all might make waves in the international community, although to different degrees. In order to achieve a standardization of the process, the methods forgo any attempt to measure precisely the income of the subsidiary. Rather, except for the BTT, they base income on such measures as the share of worldwide income dictated by a formula, a minimum rate of return on assets, a safe harbor range of prices or rates of return, and industry norms.

Although we expect difficulties with arm's length pricing to continue, we can find no problem-free alternative that would dictate Treasury's abandoning its current course. Formulary apportionment does not appear

to be a practical alternative because it would require all countries to agree to abandon the arm's length standard. Similarly, the minimum tax on assets and the business transfer tax would require revamping the country's entire tax structure. Expanded safe harbors appear to be potential revenue losers. Finally, expanding the methods of income allocation might result in pressure on the competent authority process and in some countries retaliating against U.S. companies within their boundaries if they perceive the new approach to be a departure from the arm's length standard leading to double taxation of their own multinational corporations. Because formulary apportionment, the business transfer tax, and the minimum tax represent fundamental changes in the tax system, these alternatives may be more difficult to implement than safe harbors or expanded allocation methods.

The approach described in Treasury's proposed regulations has a key feature—comparing income indicators from different companies—in common with the expanded allocation methods we discuss. Since both approaches may be perceived by some, to varying degrees, as departures from traditional arm's length pricing, they may provoke retaliation from other countries. However, in many ways the allocation methods may be easier to administer, provide more certainty for taxpayers, and require less case-by-case analysis than the proposed regulations. However, to the extent that these methods or any other alternatives deviate or are perceived to deviate from the arm's length standard and international agreement on the alternative is not reached, the administrative burden related to the competent authority process and the corresponding need for case-by-case analysis might increase.

Regardless of the nature of regulations that are adopted in the future, IRS is in a good position to continue exploring the use of arbitration in transfer pricing cases. IRS has begun promoting arbitration, and international agreements have recently addressed its use.

Agency Comments and Our Evaluation

Treasury commented that our draft report was generally an excellent summary of current thinking in transfer pricing. However, it said, the draft omitted points related to (1) treaty requirements for using the arm's length standard, (2) the impact on competent authority of unilaterally adopting alternatives to the current arm's length pricing approach, and (3) techniques of income shifting. Where appropriate, we have clarified this chapter and chapter 1 to accommodate these concerns.

Objectives, Scope, and Methodology

Objectives

In responding to the request from Senator Jesse Helms, we had three objectives: (1) to determine whether FCCs in various industries might have underpaid federal and state income taxes by improperly using transfer pricing; (2) to determine what factors, if any, affected IRS' capacity to determine and recover any potentially underpaid taxes, and (3) to evaluate alternatives to the current arm's length approach to transfer pricing.

Scope and Methodology

SOI data. To determine whether FCCs might have underpaid their taxes, we analyzed 1983-1987 data from IRS' SOI Division. We compared various financial measures and ratios for all FCCs to those same ratios for all other companies. These indicators—similar to those used by others studying transfer pricing issues—included the numbers of firms showing profits and encompassed percentages of gross profit, net income, and taxes paid to sales.

Using these same indicators, we also compared foreign and domestic companies for the 10 industries that in total comprised 50 percent of the 1987 sales of all FCCs. We did further analyses by country or group of countries of the 5 wholesale industries within the top 10 industries.

Because of the complex nature of the sample used to develop the SOI database, we did not calculate sampling errors or confidence intervals for the ratio estimates presented in chapter 2 and in appendix II. Thus, we were not able to determine if the reported ratios in any of the tables were statistically different from one another. In consultation with IRS officials expert on SOI data, we developed a procedure designed to increase our confidence in the reliability of the ratio estimates. This procedure is based on the fact that all large firms—in this case, basically those with assets of $100 million or more—are included in the SOI sample of firms; thus, estimates for these large firms have no sampling error.

Following this procedure, we recalculated the 1987 ratios in tables 2.1, 2.2, II.2, and II.3 and in figures 2.1 and II.1 through II.6 using only these large firms. If the recalculated ratios did not, in our opinion, differ greatly from the original ratios, we report the original estimates without qualification. However, in the few cases in which the recalculated ratios were quite different from the original ratios—parts of tables 2.1, 2.2, II.2, and II.3—we note the unreliability of the ratio estimates and caution the reader that comparisons of the ratios may be misleading.

Lists of transfer pricing findings. From IRS we compiled the following breakdowns of cases in which IRS noted section 482 issues:

- international examinations, by industry, completed in 1989 and 1990;
- appeals cases closed in the years 1987 through 1990;
- appeals cases open as of April 30, 1991;
- cases slated for litigation as of September 30, 1990; and
- large case examinations still open as of the same date.

We used September 30, 1990, as our cutoff date for our breakdowns to the extent that information was readily available. For each of these lists, either IRS identified for us which companies were foreign controlled, or we derived the ownership status from information IRS provided us. We did not audit the various systems that IRS used to collect information on proposed IRS adjustments to taxpayer income but noted that IRS used them for various management purposes.

Estimates for states. To estimate the potential effect of section 482 problems at the state tax level, we attributed the largest 1989 IRS international examination findings to various states. To do this, we allocated the IRS-proposed additions to taxable income to the states based on each state's share of total employment by foreign-controlled U.S. affiliates.[1] We then multiplied each state's increase in income by that state's maximum corporate tax rate for 1989. We used the maximum because this rate generally went into effect at taxable income levels of $100,000 or less.

Interviews, reading, and training. To determine what factors, if any, affected IRS' capacity to determine and recover any taxes underpaid due to transfer pricing abuse, we did the following:

- interviewed people in private industry and academia and in the U.S., British, French, German, and Japanese governments;
- studied reports and other documents covering section 482; and
- attended transfer pricing conferences and seminars sponsored by IRS and other organizations.

[1]When formulary apportionment is used to allocate a corporation's income among states as described in chapter 4, one of the factors on which the allocation is often made is the proportion of the corporation's payroll in each state. We are using state employment shares as a surrogate for state payroll shares to estimate FCC activity in particular states. This information is the closest we could find that would approximate one of the apportionment factors, and we believe it is a good proxy for payroll data.

We also attended IRS and other congressional hearings.

Cases. To gain a deeper understanding of these factors in particular circumstances, we reviewed documents and had discussions with IRS relating to 12 foreign-controlled taxpayers in 6 industries with parent companies in 5 countries. In each of these cases, IRS proposed a section 482 adjustment to taxable income.

We selected these cases by going to four districts that had larger numbers of section 482 cases than other districts had. In each district, we asked IRS officials to choose for us at least one completed examination case that showed their success in dealing with section 482 issues in terms of IRS' ultimate collection of taxes assessed, amount of resources used, and the amount of time taken to resolve the case. We also asked them to choose at least one case that illustrated their lack of success in those areas. Because of the amount of interest that congressional parties expressed in the automobile industry, we also included cases in that industry in which transfer pricing was a major issue and cases in which it was not. In general, the cases chosen had gone through different stages of IRS examinations, appeals, litigation, and competent authority processes.

Because of the different number of automobile and other section 482 cases in different districts, we examined between one and five cases in each one. We did not intend these cases to be representative of a larger universe; rather, we analyzed them only to be able to illustrate the various general factors we were otherwise hearing or reading about. We also recognized the inherent limitations in analyzing cases chosen for us by IRS officials.

In each of the four districts in which we studied cases, we held broad-ranging discussions with IRS officials about the district's past, current, and future efforts on transfer pricing. We also held discussions in two other districts that we selected because of the large number of section 482 cases or the presence of an interesting section 482 issue. In addition, we discussed district perceptions of the difficulties of dealing with transfer pricing issues. We decided that we would not select cases in the two additional districts because district officials told us that the character of section 482 issues had changed recently or that the district had not had many inbound section 482 cases.

Analysis of alternatives using criteria. To evaluate alternatives to the current arm's length approach to transfer pricing, we selected ideas that

illustrate the wide variety of possibilities for dealing with transfer pricing problems. Beyond the interviews, reading, and training described earlier, we analyzed each alternative using specific criteria based on accepted principles of taxation. These criteria were (1) the administrability of the alternative, (2) the degree to which each alternative might or might not interfere with economic decisionmaking, (3) the extent to which each might produce an accurate measurement of taxable income, and (4) any impact on international cooperation.

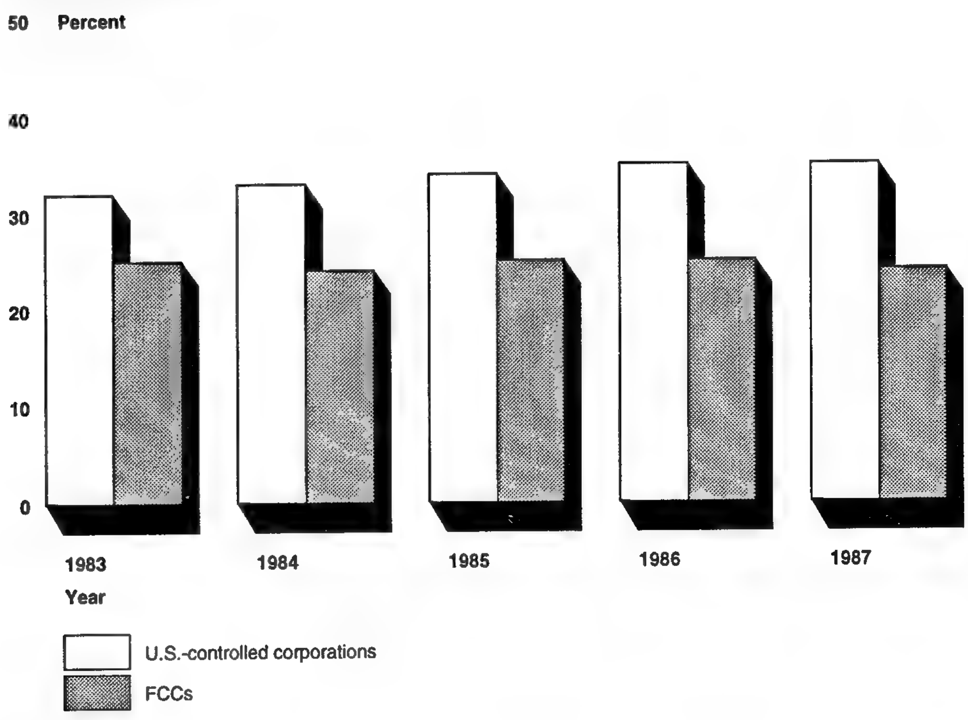
More Details on Comparisons of FCCs and U.S.-Controlled Corporations

This appendix presents statistics derived from the SOI database beyond those presented in chapter 2. It should be read in conjunction with chapter 2 for an understanding of the qualifications that apply to the numbers.

More Overall Differences Between FCCs and Domestic Corporations

Figure II.1 shows gross profit percentages for U.S.-controlled corporations rising slightly between 1983 and 1987, from 32 to 35 percent, while the FCC gross profit percentage remained at about 25 percent. The lower gross profits to sales ratio for FCCs indicates that FCCs paid more for goods they obtained as a percentage of sales than domestic corporations did.

Figure II.1: Gross Profit as a Percentage of Sales, 1983-1987

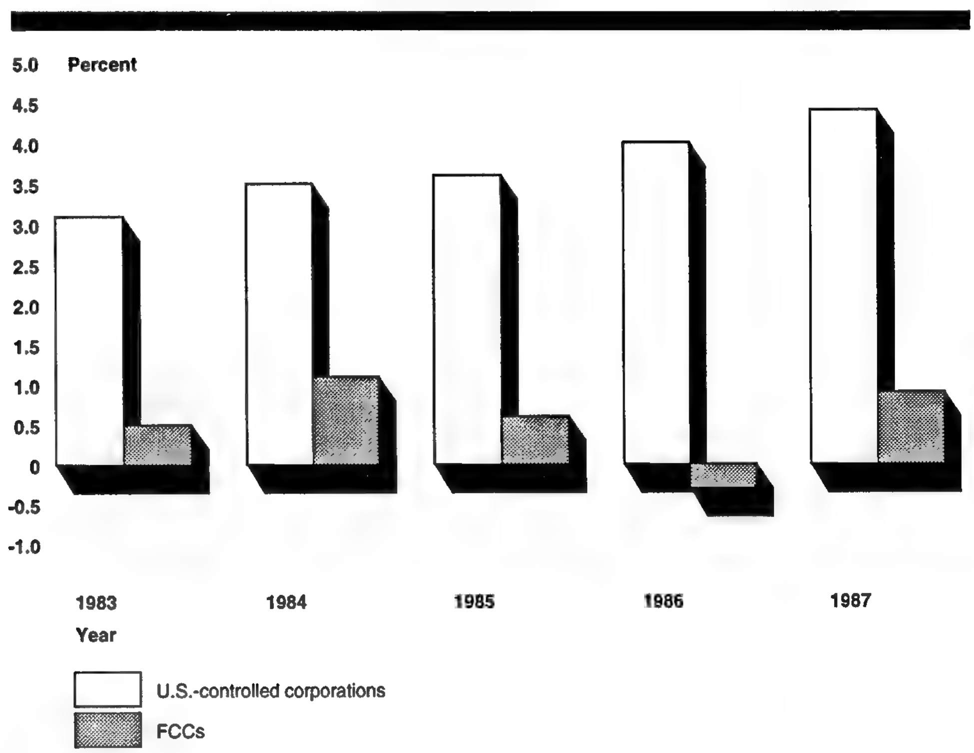


Note: Estimates are based on sample data.

Source: SOI data.

As figure II.2 shows, net income as a percentage of sales for U.S.-controlled corporations also increased steadily between 1983 and 1987, growing from 3.1 percent to 4.4 percent. In contrast, the FCC net income percentage was lower and less stable, fluctuating between 1.1 and –0.3 percent.

Figure II.2: Net Income as a Percentage of Sales, 1983-1987



Note: Estimates are based on sample data.

Source: SOI data.

As table II.1 shows, both FCC and domestic corporations' sales grew in all years from 1983 through 1987. However, the percentage year-to-year growth in sales for FCCs exceeded that for domestic corporations in each year. The change in net income was more erratic than the change in sales during this period; while net income increased every year for domestic corporations, FCC net income declined in 2 years despite rising sales.

Table II.1: Growth Rates for U.S.- and Foreign-Controlled Corporations, 1983 Through 1987

	1983	1984	1985	1986	1987
U.S.					
Level ($ billion)					
Sales	5,605.1	6,054.9	6,390.1	6,470.7	6,706.2
Net income	173.0	213.0	230.8	260.2	292.3
Growth rate (%)					
Sales	[a]	8.0	5.5	1.3	3.6
Net income	[a]	23.1	8.4	12.7	12.3
Foreign					
Level ($ billion)					
Sales	359.8	423.6	473.9	497.3	632.7
Net income	1.8	4.5	3.0	–1.5	5.6
Growth rate (%)					
Sales	[a]	17.7	11.9	4.9	27.2
Net income	[a]	150.0	–33.3	–150.0	473.3

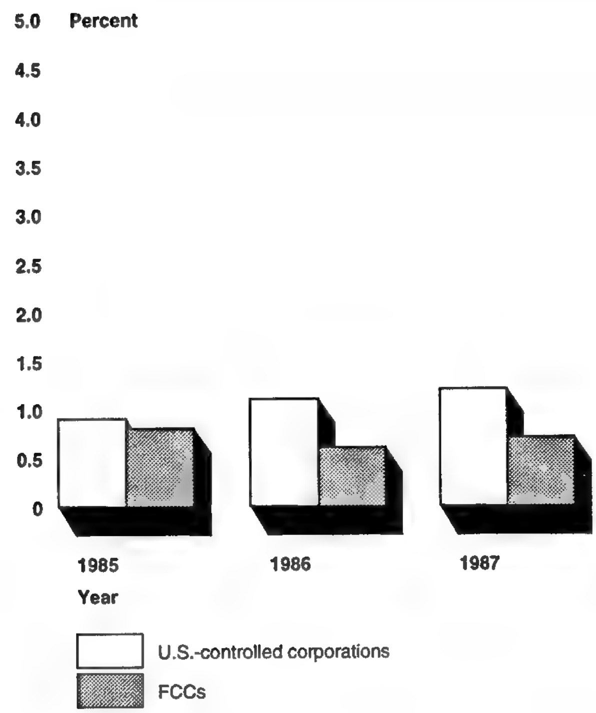
Note: Estimates are based on sample data.

[a]Because 1983 is used as the base year, an entry is not applicable here.

Source: SOI data.

Figure II.3 illustrates that taxes paid by U.S.-controlled corporations as a percentage of sales grew in each year for which data were available—from 1985 to 1986 and from 1986 to 1987. Taxes paid as a percentage of sales by U.S.-controlled firms were higher than those paid by FCCs in each year.

Figure II.3: Taxes Paid as a Percentage of Sales, 1985-1987



Note: Estimates are based on sample data.

Source: SOI data.

More Differences Within Large Industries

According to officials from government, industry, and academia, FCCs may claim very high deductions in certain expense categories as a way of lowering their net income and decreasing their federal tax liability. We examined three categories that we saw cited: advertising, interest, and other deductions.[1] Table II.2 shows the results for 1987.

[1]Other deductions are all allowable deductions not deductible elsewhere on the corporate income tax return.

Table II.2: Selected Expense Items as Percentages of Sales in Top 10 Industries, 1987

	FCCs	U.S.-Controlled
Advertising expense	1.5	0.7
Interest expense	3.0	3.6
Other deductions[a]	5.8	8.1
Depreciation expense	2.6	3.0
Cost of goods sold	82.3	74.4

Note 1: The industries selected accounted for 50 percent of foreign-controlled sales in 1987.

Note 2: Estimates are based on sample data.

[a]So much variability existed in the data that comparing the other deductions ratios for FCCs and U.S.-controlled corporations could be misleading.

Source: SOI data.

In the top 10 industries, we found that advertising expenses as a percentage of sales were consistently higher for FCCs than for their domestic counterparts; however, the percentages were very small for both groups. Interest expenses as a percentage of sales were also very small for both groups and for 3 years—1985 through 1987—it was higher for domestic corporations. Further, in each of the years examined, except 1983, domestic corporations claimed higher other deductions as a percentage of sales than did their foreign-controlled counterparts. However, we found that so much variability existed in the data that comparison of FCC and U.S.-controlled other deduction ratios for 1987 could be misleading.

Potentially higher depreciation expenses associated with the start-up of U.S. operations has been suggested as an alternative to transfer pricing abuse as a possible reason for the lower profitability of FCCs. We found that FCCs in the 10 industries we analyzed claimed higher depreciation costs as a percentage of sales in 1983 and 1984 than domestic corporations in the same 10 industries. However, in the subsequent years analyzed—1985 through 1987—U.S.-controlled corporations claimed higher depreciation costs as a percentage of sales than FCCs in these industries. Table II.2 also shows the depreciation percentages for 1987.

In addition, table II.2 shows, for comparative purposes, cost of goods sold percentages for 1987. As shown in the table, FCCs for the 10 industries had a higher ratio of cost of goods sold to sales than the U.S.-controlled companies did. This relationship also held true for 1984 through 1986, although the differences were not as large as in 1987.

More Differences Within Wholesale Industries

As exemplified by 1987 in table II.3, the five industries within the wholesale group were not uniform in their FCC and domestic comparisons. Two of them—machinery, equipment, and supplies and other durable goods—had low ratios for FCCs compared to the domestic corporations in the same industries in 1987 and also in 1983 through 1986, years not shown in table II.3. Although FCCs in the metals and minerals industry had a higher net income ratio than the domestic corporations in 1987, in the other years FCCs had much lower ratios than domestic corporations in that industry. FCCs in the electrical goods category also had lower ratios than their domestic counterparts, but the differences were not as large in the two earliest years, 1983 and 1984.

Table II.3: Gross Profit, Net Income, and Taxes Paid as Percentages of Sales for FCCs and Domestic Corporations in Wholesale Industries, 1987

	Gross profit	Net income	Taxes paid
Machinery, equipment, and supplies			
Foreign-controlled	15.9	(0.1)	0.5
U.S-controlled	27.2	1.7	0.7
Motor vehicles and automotive equipment[a]			
Foreign-controlled	11.1	0.8	0.9
U.S-controlled	22.2	1.6	0.7
Metals and minerals[b]			
Foreign-controlled	2.3	0.3	0.1
U.S-controlled	8.2	0.2	0.3
Electrical goods			
Foreign-controlled	19.8	0.3	0.6
U.S.-controlled	25.0	2.1	0.9
Other durable goods			
Foreign-controlled	11.4	0.5	0.4
U.S.-controlled	23.3	1.7	0.7

Note: Estimates are based on sample data.

[a]The estimates in the taxes paid column for this industry are not reliable. In fact, when only corporations with assets of generally $100 million or more were considered, FCCs had a lower taxes-paid-to-sales ratio than U.S.-controlled corporations did, just as they did for the other four wholesale industries on this table.

[b]Because of variability within the data for this industry, comparing the FCC and U.S.-controlled ratio estimates in the various columns could be misleading.

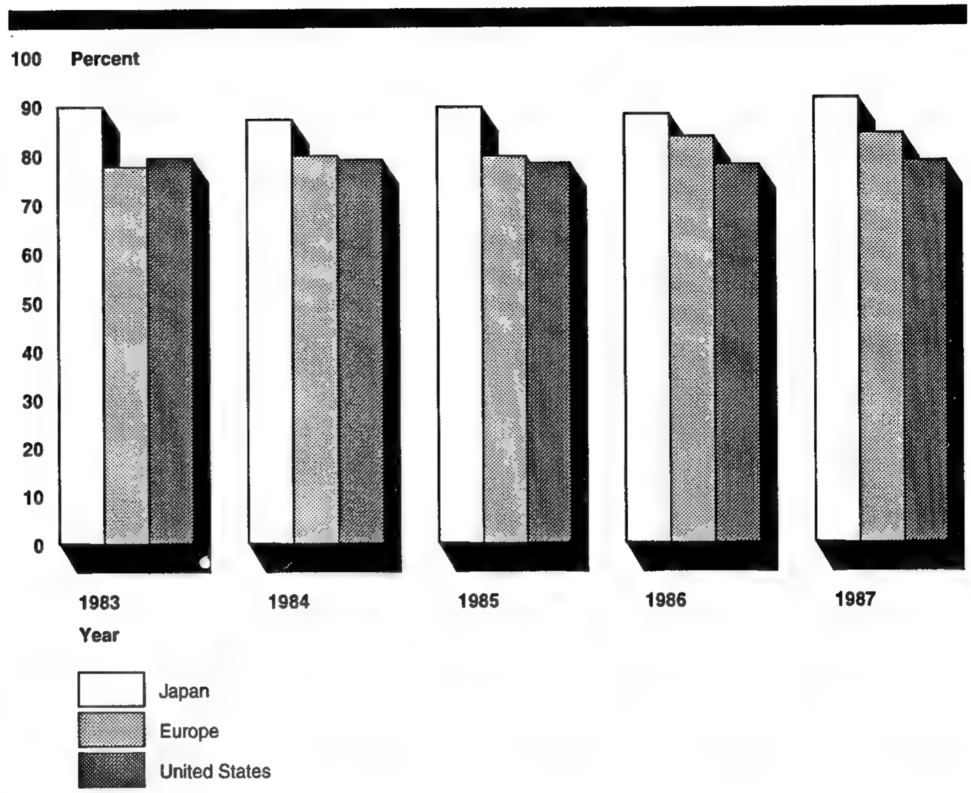
Source: SOI data.

Only the motor vehicle industry showed a different pattern; although gross profit as a percentage of sales for FCCs was consistently lower than that of domestic corporations, the FCCs had higher net income in relation to sales in all years except for 1987 and paid more taxes as a percentage of sales than the domestic corporations did in the 3 years—1985 through 1987—for which taxes paid data were available from SOI. On the basis of our analysis, we know, however, that for 1987 the estimates for the taxes paid ratios were not reliable because of variability in the data. When we considered only corporations with assets of generally $100 million or more, FCCs actually had a lower ratio of taxes paid to sales than U.S.-controlled corporations did.

More Differences by Country Group Within Wholesalers

An analysis covering 1983 through 1987 shows consistent differences between Japanese- and U.S.-controlled wholesale corporations in cost of goods sold as a percentage of sales, while differences between European- and U.S-controlled corporations are more varied. Figure II.4 shows the cost of goods sold (and by extension, the gross profit) as a percentage of sales for Japanese-, European-, and U.S.-controlled wholesale firms over time. The cost of goods sold for the Japanese wholesale firms was about 90 percent of sales between 1983 and 1987. The Japanese ratio was consistently higher than the cost of goods sold percentages for both European and domestic firms, meaning that the Japanese-controlled firms paid more for goods they obtained as a percentage of sales than the other companies did.

Figure II.4: Cost of Goods Sold as a Percentage of Sales for Wholesale Firms, by Location of Parent Company



Note 1: Europe here consists of the United Kingdom, West Germany, and France.

Note 2: Wholesale here consists of machinery, equipment, and supplies; motor vehicles and automotive equipment; metals and minerals; electrical goods; and other durable goods.

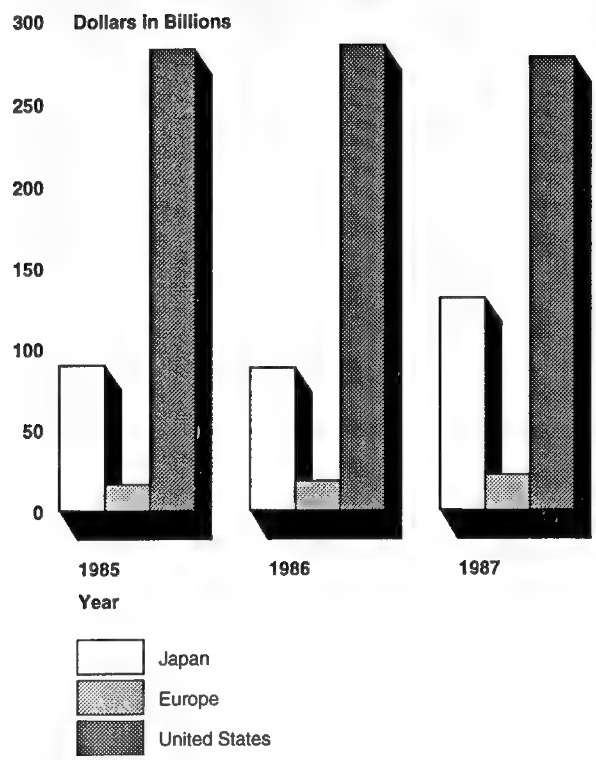
Note 3: Estimates are based on sample data.

Source: SOI data.

Figure II.5 shows the 1985-1987 sales for Japanese-, European-, and U.S.-controlled corporations in the wholesale industries we analyzed. Figure II.6 shows the 1985-1987 taxes paid by the same corporations. Taxes paid by Japanese- and European-controlled wholesalers decreased in 1986 from 1985, even as sales increased. In 1987, the taxes paid by Japanese-controlled corporations continued to decline in spite of rising sales. Sales for European-controlled companies continued to increase in 1987, while taxes paid by these firms rose slightly. Both sales and taxes

paid by U.S.-controlled corporations rose slightly between 1985 and 1986 and declined in 1987.

Figure II.5: Sales of Wholesale Firms, by Location of Parent Company, 1985-1987



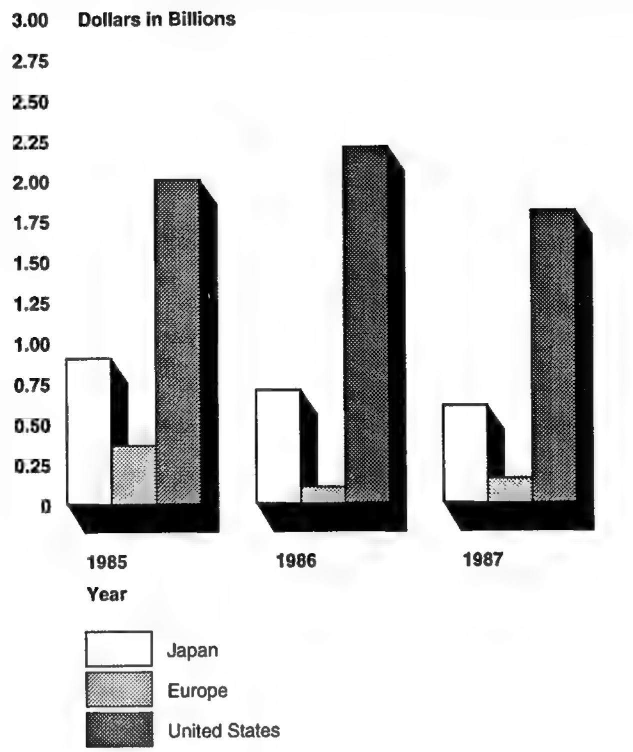
Note 1: Europe here consists of the United Kingdom, West Germany, and France.

Note 2: Wholesale here consists of machinery, equipment, and supplies; motor vehicles and automotive equipment; metals and minerals; electrical goods; and other durable goods.

Note 3: Estimates are based on sample data.

Source: SOI data.

Figure II.6: Taxes Paid by Wholesale Firms, by Location of Parent Company, 1985-1987



Note 1: Europe here consists of the United Kingdom, West Germany, and France.

Note 2: Wholesale here consists of machinery, equipment, and supplies; motor vehicles and automotive equipment; metals and minerals; electrical goods; and other durable goods.

Note 3: Estimates are based on sample data.

Source: SOI data.

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

April 3, 1992

Mr. Richard L. Fogel
Assistant Comptroller General
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Assistant Comptroller General Fogel:

Thank you for your draft report on transfer pricing dated March 5, 1992 that you sent to Secretary Brady. Secretary Brady asked me to respond directly to you because the report concerns a matter of tax policy.

The draft report, while generally an excellent summary of current thinking in the area of transfer pricing, omits three points. First, the report does not refer to the requirement, contained in some 40 tax treaties between the United States and its major trading partners, that transfer pricing (and other) adjustments to the profits of associated and affiliated companies conform to the "arm's length" standard. Under the arm's length standard, adjustments must reflect the commercial and financial relations that prevail between independent companies. The treaty obligation to adhere to the arm's length standard would be violated if the United States adopted formulary or safe harbor approaches that were inconsistent with that standard.

Second, in discussing the effect of safe harbors or formulary approaches, the study does not refer to the mutual agreement procedures also contained in our tax treaties. Under these procedures, taxpayers may request the United States "competent authority" (Internal Revenue Service - Assistant Commissioner International) to resolve, either unilaterally or in bilateral negotiations with the treaty partner, any case of "double taxation." (Double taxation occurs when two or more countries impose tax on the same dollar of income.) Transfer pricing cases involving a U.S. company and an affiliate that is resident in a country with which we have a tax treaty often end up in the competent authority process. To the extent that the United States adopts methods (such as safe harbors or formulary methods) that conflict with the arm's length standard used by our treaty partners, increasing numbers of double taxation cases inevitably will arise.

This increased incidence of double taxation would be harmful in at least two ways. First, it would add to the case load of the competent authority. Although the IRS is working to improve the process, the competent authority process (which is the subject of another GAO study) can be very time-consuming. Increasing, in any

substantial way, either the number of competent authority cases or the breadth of disagreement within those cases, would increase the overall administrative burden on the IRS. Second, the U.S. competent authority would find itself at a disadvantage in negotiations with the foreign competent authorities. Since the relevant standard employed at the examination level would be a formula or safe harbor that might not reflect the arm's length standard, the need to resolve the case on the basis of the arm's length standard set forth in our treaties would require the competent authority to develop the case on the basis of this standard without the case development that the IRS currently performs at the examination level. This necessity to develop the case completely at the competent authority level would put the U.S. competent authority at a distinct disadvantage, since the foreign competent authority generally will have the benefit of thorough case development under the arm's length standard at the examination level. This disadvantage could lead to greater revenue losses and/or greater double taxation. Of course, this problem would not arise in cases involving non-treaty partners (including most tax havens), since competent authority will not be involved in such cases.

A third important omission of the report is that it fails to address the claims by foreign countries (especially Japan) and multinational corporations that there is no advantage in shifting income from one high-tax country (such as the United States) to another (such as Japan). The study should examine whether, or at least refer to the possibility that, this criticism is unfounded because multinationals in high-tax countries shift income to levels in the chain of production of goods upstream from the level of the operating company that is the subject of the transfer pricing inquiry, or other factors.

Sincerely yours,

Alan J. Wilensky
Deputy Assistant Secretary
(Tax Policy)

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

APR 7 1992

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

We appreciate the opportunity to review your draft report entitled "International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (Report)."

The Report makes three recommendations regarding IRS resource and workload allocations in the intercompany, or transfer, pricing area. These recommendations are consistent with efforts that the IRS has been undertaking for several years. For example, in October, 1991, the Office of the Assistant Commissioner (International) formed an International Compliance Analysis Division 1) to identify multinational trends and their impact on tax administration; 2) to identify international tax issues and market segments that warrant increased examination coverage; and 3) to develop alternative training sources and materials for international issues courses. Also, the IRS implemented the International Field Assistance Specialization Program in early 1991 to provide centralized expertise and coordination of Section 482 issues.

The IRS has made international compliance a priority in its Strategic Business Plan (Plan). The FY 1992 Plan has a specific initiative relating to foreign controlled corporations. The Plan calls for identifying significant market segments and developing baselines and measures for voluntary compliance. The Office of Chief Counsel also has special trial attorneys for international issues. The IRS believes that these efforts, together with recent legislative changes, are having a meaningful impact on the enforcement of Section 482 in both inbound and outbound cases.

The Report analyzes a number of alternatives to the arm's length standard for determining intercompany transfer pricing. We observe that any domestic changes likely would attract strong objection from U.S. treaty partners, and could result in double taxation of U.S. based multinationals if the changes are not generally accepted in the international community. Thus, changes should not be made without careful study and coordination with treaty partners. Also, any changes of this nature would require legislative action.

Our specific comments on each of these recommendations are enclosed. We hope you find these comments useful.

Best regards.

Sincerely,

Shirley D. Peterson

Shirley D. Peterson

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN THE GAO DRAFT REPORT ENTITLED
"INTERNATIONAL TAXATION: PROBLEMS PERSIST IN DETERMINING
TAX EFFECTS OF INTERCOMPANY PRICES"

GAO RECOMMENDATION

We recommend that the IRS Commissioner develop an optimal workload planning and staffing system and continually use it to provide ongoing information at the national level for assessing international staffing needs to best meet the international workload.

IRS COMMENT

The IRS is developing optimal workload planning and staffing mechanisms in the international area. Over the past several years, the IRS has significantly emphasized the development of international issues in its examinations. This emphasis must, however, be balanced with other major compliance programs.

GAO RECOMMENDATION

We recommend that the IRS Commissioner formally plan, possibly through IRS' new International Compliance Analysis Division, how IRS will put together all of its data to study trends in the types of 482 findings, in intercompany transactions, and in 482 case dispositions, and how it will act on the trends so as to improve compliance once they are identified.

IRS COMMENT

The International Compliance Analysis Division was formed by the Office of the Assistant Commissioner (International) in October 1991. Its mission is to 1) identify multinational trends and their impact on tax administration; 2) identify international tax issues and market segments that warrant increased examination coverage; and 3) develop alternative training sources and materials for international issues courses. Current projects include foreign tax credit, financial products, and IRC 482 intercompany pricing issues.

GAO RECOMMENDATION

We recommend that the IRS Commissioner use IRS' new 482 specialists to monitor all 482-related information initiatives being taken, be involved in periodically determining how many IRS staff may be needed for 482 issues, and raise for discussion policies that conflict with an ongoing emphasis on 482.

IRS COMMENT

The IRS established issues expertise in early 1991 with the implementation of the International Field Assistance Specialization Program was established. The Program comprises a National Administrator and four International Issue Specialists in the areas of Inbound Section 482 intercompany pricing, Outbound Section 482 intercompany pricing, Controlled foreign corporations, and International financial transactions. This field assistance program is designed to provide practical "how to" technical assistance in identifying and developing complex international tax issues. This helps the IRS achieve Service-wide consistency in the treatment of tax issues. The international specialists have responsibilities to develop and disseminate audit techniques, consult with Counsel and examiners on issues, and train others in their areas of expertise.

With the developments discussed above, we believe that significant improvements have been made in our international compliance efforts, and in our ability to effectively enforce the international transfer pricing rules.

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